

Volume 11

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

BEFORE THE HONORABLE EDWARD M. CHEN, MAGISTRATE JUDGE

SECURITIES AND EXCHANGE)	
COMMISSION,)	
)	
Plaintiff,)	
)	
VS.)	NO. C 08-4238 EMC
)	
MICHAEL C. PATTISON,)	
)	San Francisco, California
Defendant.)	Tuesday
)	September 21, 2010
)	8:06 a.m.

TRANSCRIPT OF TRIAL PROCEEDINGS

APPEARANCES:

For Plaintiff: U.S. Securities and Exchange Commission
44 Montgomery Street, Suite 2600
San Francisco, CA 94104
(415) 705-2456
(415) 705-2500 (fax)
BY: SUSAN F. LAMARCA
ROBERT L. TASHJIAN
WILLIAM SALZMANN

For Defendant: Nossaman, LLP
50 California Street, 34th Floor
San Francisco, CA 94111
(415) 398-3600
(415) 398-2438 (fax)
BY: PATRICK J. RICHARD
BRENDAN F. MACAULAY
JAMES VORHIS

Reported By: Belle Ball, CSR 8785, RMR, CRR, and
Lydia Zinn, CSR 9223, RPR
Official Reporters - U.S. District Court

Belle Ball and Lydia Zinn
Official Reporters, U.S. District Court
(415) 373-2529

1 **TUESDAY, SEPTEMBER 21, 2010**

8:06 A.M.

2 **P R O C E E D I N G S**

3 (The following proceedings were held in open court,
4 outside the presence and hearing of the jury.)

5 **THE COURT:** Good morning, everyone.

6 **MS. LAMARCA:** Good morning.

7 **MR. RICHARD:** Good morning, your Honor.

8 **THE COURT:** Okay. So I thought we would take this
9 time to talk about the motion for judgment as a matter of law,
10 and then also spend some time talking about the instructions.
11 I can't devote the whole half an hour to the motion, and I
12 don't think we need to, because I've read the briefs; but why
13 don't I -- I have some questions. Why don't we just get into
14 it?

15 Mr. Richard, why isn't it, on the question of
16 materiality, that we have a restatement itself, which has
17 the -- assuming you're right, that the focus should be on the
18 information omitted, and not the fact of the omission, and
19 therefore, you know, if one were to go down the road of an
20 event analysis, there's some question about whether, you know,
21 the first press release really, you know, has any probative
22 value with respect to materiality or not -- at least I
23 understand your argument, but why isn't it when we actually
24 have a number -- \$14.6 million, as measured against income, et
25 cetera -- why isn't it enough for a finder of fact -- i.e., the

1 jury -- to say, "Well, you know, that's not insignificant"?

2 **MR. RICHARD:** Your Honor, it's not; at least, in the
3 Ninth Circuit.

4 We begin with the standard that the government was
5 required to produce substantial evidence that -- from which the
6 jury could find that there was a substantial likelihood that a
7 reasonable investor would have regarded what was not disclosed
8 to him or her as having significantly altered the total mix of
9 information that he took into account in deciding whether to
10 buy or sell the security.

11 And there are two ways to address materiality,
12 your Honor. You could either present evidence that in the
13 period 2000 to 2004, here's how the reasonable investor would
14 have considered that information in the context of making their
15 investment decision in the total mix of information available
16 to them. That's right out of the jury instruction.

17 If you're not going to present evidence as to how a
18 reasonable investor would have used this information -- this
19 noncash expense -- in making an investment decision, then the
20 other way is: Well, let's look and see what happened later to
21 see if, when the information was disclosed, it impacted the
22 share price, and we can draw an inference that the information
23 was material, because we look at the how the market reacted,
24 and we can assume that the information that was withheld caused
25 the stock price to be overvalued. Your Honor's question --

1 **THE COURT:** Let's focus on the first one. That's
2 what I'm focusing on. And --

3 **MR. RICHARD:** Yes, your Honor.

4 **THE COURT:** How a reasonable investor would have used
5 the information? Are you saying that the Ninth Circuit law
6 requires expert testimony, no matter what, on how a reasonable
7 investor values things and thinks?

8 **MR. RICHARD:** The Ninth Circuit hasn't come out and
9 said that.

10 The cases that address -- if you're going to try to
11 prove it by pointing to subsequent events, then you absolutely
12 need expert testimony to explain what conclusions, if any, can
13 be drawn from a subsequent change.

14 **THE COURT:** I'm focusing on prong one, the first one
15 you said. And that is: We have the information that should
16 have been considered. We know the magnitude.

17 **MR. RICHARD:** Well --

18 **THE COURT:** And at least we know the dollars.

19 So what seems to be missing is any specific evidence
20 of how that would have been relevant or evaluated by a
21 reasonable investor.

22 **MR. RICHARD:** Yes, your Honor. Your Honor's
23 question -- and -- and it gets -- I do want to talk about the
24 evidence that the -- that the government points to, because
25 I -- it really does highlight the total failure of proof on

1 this point. It is not enough to go to the jury. And it
2 shouldn't go to the jury, because it's a confusing point, as
3 your Honor just raised the question: Well, there was a
4 \$14 million restatement. Isn't that material?

5 That begs the question. There's not a presumption
6 that economic materiality -- that just because you have a
7 restatement means that it has --

8 Accounting materiality and economic materiality are
9 different. And the case that address the point all speak to
10 cash flow, revenue, and -- and information that is related to
11 the value of stock or the value of the company.

12 So, without testimony as to how this noncash
13 compensation expense would -- could be used by a reasonable
14 investor in light of the total mix of information available,
15 no, your Honor, there is no substantial evidence on that point.

16 So to answer your question, it is not enough --
17 cannot be enough -- simply to point to a restatement on a
18 noncash expense and say, "Well, let the jury figure out how a
19 reasonable shareholder would have used that information in the
20 total absence of any testimony as to how that noncash expense
21 item -- whether it was a dollar or a million dollars or
22 \$14 million -- would have affected a reasonable investor's
23 decision."

24 **THE COURT:** Well, isn't it some point -- for
25 instance, if it turned the net operating income from positive

1 to a negative, are you still saying even under those
2 circumstances, you need some expert to say, "Here's how a --
3 this is why a reasonable investor would have been affected?"

4 Or what if it cut net income by half? I mean, at
5 some point isn't there enough for a jury to say, "Well, looks
6 like enough to me"?

7 **MR. RICHARD:** No, your Honor. I think the question
8 is: Would what a reasonable investor considers -- is that
9 beyond the scope of the average juror?

10 And I think that in this case, it is.

11 I think that, to -- to group all --

12 **THE COURT:** That is implying a per se rule that
13 the -- what a -- in order to implement the jury instruction, a
14 juror cannot use common experience and what they've seen here
15 in numbers. They need expert testimony?

16 **MR. RICHARD:** In this case, your Honor, where we're
17 not talking about any information that affects revenues or cash
18 flow, absolutely.

19 It's essential, because it's misleading, as we've
20 heard from the witness we called that the government chose not
21 to call about the distinction between cash and then noncash
22 expenses. So, for the very reason that your Honor's asking the
23 question, "Well, there was a restatement, and it was
24 \$14 million isn't that enough," the answer is "No." We have to
25 understand. How would that information have been used by a

1 reasonable investor? And, to turn it over to the jury and say
2 "\$14 million is a big number, and it affected earnings per
3 share. It affected net income," when all the evidence that,
4 you know -- that -- we're here because the government chose not
5 to present any evidence as to how this information could or
6 would have been used by a reasonable investor in making an
7 investment decision.

8 Instead, they're hoping your Honor will just allow
9 the case to go to the jury and say, "Restatement, restatement,
10 restatement. \$14 million."

11 That's not enough.

12 And if we look at the case law that the government
13 cited, they ellipsed out the references to revenues in the *SEC*
14 *versus System Software Associates* case from the Northern
15 District of Illinois cited at page 4 of their brief.

16 It's quite telling that the government puts in a
17 quote that says,

18 "A financial statement that does not
19 conform to the requirements of GAAP is
20 presumptively a false or misleading
21 statement."

22 When what the case said -- and why they ellipsed out
23 two words -- three words. The case actually said,

24 -- "a financial statement that
25 recognizes revenue and does not conform."

1 Well, revenue and cash flow, your Honor, are the
2 basis on which valuations are made. They know that. Their
3 expert knows that. Mr. Bravo knows that. The Northern
4 District of Illinois court knows that.

5 To jump from, well, revenue, and therefore noncash
6 expense -- aren't they really all the same?

7 No. You need to sort that out with someone who knows
8 what they're talking about.

9 **THE COURT:** What's your best authority? What's your
10 best case for the proposition that where there's not an obvious
11 impact on revenue or cash flow, but only on stated operating
12 income, because of noncash expense, you need an expert? Is
13 there any case that says that --

14 **MR. RICHARD:** Yeah, I think you --

15 **THE COURT:** -- or close to that?

16 **MR. RICHARD:** We did cite a couple of cases on the
17 importance of expert testimony. I only hesitate because the --
18 the -- when you look at the subsequent period and try to draw
19 conclusions about what happened then --

20 **THE COURT:** Yeah. Well, that's under number two. I
21 understand that.

22 **MR. RICHARD:** Okay.

23 **THE COURT:** But that's, perhaps, a little more
24 complicated.

25 **MR. RICHARD:** In looking at each of the cases that

1 the government cited, they refer to cash flow or revenue for
2 the proposition -- I guess I didn't think of it in terms of
3 expert or nonexpert on the question of substantial evidence as
4 to how a reasonable juror would have used that information.

5 **THE COURT:** Okay, but you're saying all of the cases
6 cited by the government -- all pertain to actual cash flow
7 revenue; none of them deal with noncash, what one might call,
8 sort of, a technical bookkeeping --

9 **MR. RICHARD:** To the extent they address it.

10 There was one case. I think it was either on a
11 motion to dismiss -- where they just relied on allegations in
12 the complaint or a motion for class certification; but to the
13 extent that the cases cited at page 4, if you actually look at
14 the *Murphy* case, and -- the *SEC-Murphy*, and then the *SEC versus*
15 *System Software*. *Murphy* plainly repeatedly talked talks about
16 cash flow. And the *System Software* case talks about
17 recognizing revenue.

18 **THE COURT:** All right. Let me hear from the
19 Commission on this first point, before we get to any
20 after-events analysis.

21 **MS. LAMARCA:** Sure.

22 **THE COURT:** What about that?

23 **MS. LAMARCA:** Okay. So, first of all, we would not
24 agree that whether something is categorized on a balance sheet
25 as a, quote, "noncash expense," means that it's not a technical

1 violation or that it's -- has any other -- excuse me -- that it
2 somehow escapes his presumption that GAAP violations are
3 presumptively material. And so -- just to sort of set the
4 record straight on that.

5 And the other thing I think that has been overlooked
6 in this is: There is a cash consequence to these options.
7 When the company issues an option to an employee for, let's
8 say, \$5, and could have, if it was really giving it on the
9 right -- on the day it said it was -- today or, you know, the
10 day that they made the options, and really gave it at fair
11 market value, and fair market value was up to \$7, that's a \$2
12 difference that that employee doesn't have to pay. And that
13 wouldn't go into the company's coffers if it were cashed in.

14 So it's -- yes, the accounting, just like for
15 depreciation and other expenses, expenses we saw in cases like
16 *Enron* and *WorldCom* and *Tyco* -- even those these are categorized
17 by accountants as noncash. That doesn't make them mythical or
18 technical or anything like that. They are full-fledged
19 expenses. They have to flow through one's income statement.
20 They affect the bottom line; the net income numbers.

21 And we did see, in fact, in this case the reported
22 earnings flip to large reported losses.

23 **THE COURT:** Which -- for every year, or --

24 **MS. LAMARCA:** Not for every year, but we did see --
25 we saw for the first year a flip from a large gain -- a, you

1 know, reported earnings of 2.2 million the first year after
2 their IPO. And it flipped down to a negative; you know, a loss
3 of \$500,000. And we saw significant decreases to the reported
4 earnings -- the net income number -- at the end of the day.
5 And that affected the numbers that Embarcadero told its
6 shareholders were important, earnings per share, the things
7 they talked about in earnings calls. We heard testimony about
8 that.

9 And there is a principle as well in the case law that
10 when management thinks something is important -- important
11 enough to guide to or to talk to shareholders and investors
12 about -- then it is material.

13 **MR. RICHARD:** Okay, but --

14 **MS. LAMARCA:** Well, let me finish my point here.

15 **THE COURT:** What was that last point?

16 **MS. LAMARCA:** When management of a company regards
17 information as material --

18 **MR. RICHARD:** Is there a cite on that, please? It
19 wasn't in the brief.

20 **THE COURT:** If they regard it as material --

21 **MS. LAMARCA:** Yes.

22 **THE COURT:** -- what's the consequence?

23 **MS. LAMARCA:** Then it is a fair inference to draw
24 that it is material.

25 **THE COURT:** What's -- do you have a cite for that

1 in --

2 **MS. LAMARCA:** I actually don't have it at my
3 fingertips. I'm sorry.

4 **THE COURT:** Is it in your brief?

5 **MS. LAMARCA:** I believe it's in our brief, but I must
6 admit I can't remember.

7 And I will also tell the Court that, because we were
8 doing this within the trial, we had one of our colleagues help
9 us write this brief.

10 **THE COURT:** Yeah. It was short notice. I understand
11 that.

12 **MS. LAMARCA:** Let me continue on that same point, if
13 I may, just to respond to a couple of points raised by Counsel.

14 The Ninth Circuit case law also supports the fact or
15 the principle that the jury is allowed to look at these facts
16 and draw their conclusions based on the testimony about the
17 facts that the witnesses have described, including -- we had
18 accountants and Mr. Haroian testifying about the importance of
19 these numbers. We had testimony from our second witness,
20 Caitlin Haberberger, talking about how these financials were
21 put together and presented to the public. And I think the jury
22 can draw conclusions even from that testimony about the
23 importance of those numbers.

24 We also have --

25 **THE COURT:** I don't recall her talking specifically

1 about the magnitude or anything specific about these numbers.

2 **MS. LAMARCA:** Let me just make -- let me clarify
3 something. There are two -- there's a separate issue that I
4 think has sort of been overlooked in this discussion, is: It
5 isn't the case that we look solely to that 14.6 million. That
6 is very important number. So if the Court is asking us about
7 that, yes. I mean, I can limit all of my comments to that
8 number. However, there are other material misstatements, as
9 we've pointed out, in the financial statements prepared by the
10 defendant. And those as well deserve the jury's consideration
11 in this materiality analysis.

12 **THE COURT:** Okay. Which are those?

13 **MS. LAMARCA:** So, for instance, the easy one is the
14 claimed statement that we don't grant stock options at below
15 fair market value. And that has a lot of meaning to investors,
16 because investors think that employees are on the same page as
17 them. We heard that testimony. We also heard -- and we've
18 continued to hear it in the defendant's case. So, I mean, that
19 is going to be something that's riddled throughout this case.

20 We also heard about an investor group called "ISS,"
21 which cared at the time about that very fact.

22 **MR. RICHARD:** May I respond to your Honor's question?
23 I found the citation. I --

24 **THE COURT:** Okay.

25 **MR. RICHARD:** At page 11 of our brief, your Honor, we

1 referred to the Northern District of California decision in *In*
2 *re: Oracle Securities Litigation*, where the Court said, quote,

3 "A securities value does not fluctuate
4 with reported earnings, but varies,
5 instead, with the discounted value of
6 future cash flows which are expected to
7 accrue to the security."

8 Closed quote.

9 The argument that the -- in their brief, what the
10 government said -- and let's be clear on --

11 **THE COURT:** Well, let's take it -- for instance, if
12 that's true --

13 **MR. RICHARD:** Yes, your Honor.

14 **THE COURT:** And, of course, that's not Ninth Circuit.
15 That's a district court.

16 But assuming that's true, one of the responses I just
17 heard was that although it is treated, at least in the
18 operation statement, as a noncash expense, it ultimately
19 impacts upon the balance sheet, because if you're paying, you
20 know, \$5 a share when you exercise instead of the \$10, it
21 should have been, if the grant were at the true fair market
22 value as of the "measurement date," as we called it, that's
23 less money into the treasury when it's exercised, right?

24 **MR. RICHARD:** There are two points that absolutely
25 rebut that.

1 One: Total failure of proof on that evidence. I
2 challenge the government. It's not in their brief. It wasn't
3 in any witness' testimony how much money that would be; whether
4 it would be material. That concept didn't even come out of any
5 witness' mouth, and it cannot fairly be argued from the
6 evidence in this case.

7 But there's a second and more important point. And
8 it's a point that other courts have addressed, like the
9 *Shanahan* case we cite, where the SEC has tried to change their
10 theory of the case. And the Court went back and looked at the
11 complaint and the trial brief. And I've done that in this
12 case. And your Honor's read the complaint. And in their trial
13 brief, what they allege repeatedly -- and the issue that was in
14 the complaint is, as they say at page 2 of their trial brief,
15 quote,

16 "Pattison was in charge of accounting
17 at Embarcadero, including accounting for
18 stock options throughout this period.
19 However, Pattison caused Embarcadero's
20 publicly disclosed financial statements to
21 be materially false and misleading, as he
22 failed to record the required expense
23 associated with the granting of stock
24 options."
25 Period. Closed quote.

1 Further down on the page, at line 15, quote,

2 "Pattison knew that the options
3 Embarcadero issued to employees were
4 granted in-the-money; that is, with striker
5 exercise prices below the then-fair market
6 value of Embarcadero stock. He also knew
7 the accounting rules required that an
8 expense be recorded when options were
9 granted in-the-money or below the fair
10 market value of the company's stock
11 period."

12 Closed quote.

13 The issue before your Honor is: For that expense
14 under APB 25 for these noncash charges, how would an investor
15 ever have used that information at the time in making their
16 investment decision?

17 On that point, there's been a total failure of
18 evidence.

19 Now, we don't need to peek ahead to what Mr. Bravo
20 told us last Friday, which is absolutely consistent with what I
21 just read from the *In re: Oracle Securities Litigation*.
22 Absolutely known to the government and anyone within the SEC
23 when you get away from cash flows and revenue, and start
24 talking about a noncash compensation expense, whether it's a
25 dollar or a million dollars or \$14 million -- where is the

1 evidence as to how a reasonable investor would have used that
2 information at the time?

3 Total failure of proof.

4 And so now we hear, "Well, it's in the restatement."
5 Management said it's important. I asked Betty Jo Charles,
6 their witness, "Why is this information in here?" Because it's
7 required. I asked her that twice. Because it's required.

8 **THE COURT:** Let me ask you this other question.

9 We did hear evidence about dilution, and why people
10 care about dilution. Pieces of the pie get smaller and
11 smaller. It seems to me it doesn't take an expert to say,
12 "Well, if employees can buy stock at a deal, compared to not a
13 deal, there's going to be more exercises and more dilution."

14 **MR. RICHARD:** Okay. Now we're changing the case. If
15 this case, now, your Honor -- it's not in the complaint or
16 their trial brief, if what we're saying is, "Assume that one of
17 the four or five key terms of the stock option agreement were
18 different, would that have changed the likely exercise of the
19 stock options?" That's what your Honor's just asked.

20 If they had stock options at -- on different terms,
21 would they have exercised them differently?

22 That -- the question requires one to assume and argue
23 and present evidence and allege that, well, if the exercise
24 price had been different, wouldn't the dilutive effect have
25 been different.

1 **THE COURT:** Yeah.

2 **MR. RICHARD:** That's a very different question than
3 saying, "Mr. Wong absolutely had the right to pick whatever
4 exercise price he wanted. How was it accounted for?"

5 **THE COURT:** Well, but what they're saying is that one
6 of the material misstatements which underpins their 10(b)(5)
7 claim is not just how many dollars, but there was a statement,
8 I guess, in the notes or something about: We don't grant below
9 fair market value.

10 **MR. RICHARD:** That's just the flip side of saying,
11 "We don't take a compensation expense." That's why they don't
12 take the compensation expense.

13 **THE COURT:** Well, but if -- can't they rely on that
14 as one of the, quote, "misstatements" or alleged misstatements?
15 And if so, then you have to look at the materiality of that.
16 And that's where this, then, dilution argument comes in.

17 **MR. RICHARD:** And, your Honor, the dilution
18 argument -- if they would have had anyone say, "Here's the
19 total mix of information available on the question of
20 dilution," their case would collapse, because, as your Honor
21 knows, all of the information about dilution -- the number of
22 outstanding options, the average weighted exercise price --
23 every piece of information from which one would need to
24 determine dilution was in the total mix of information
25 available.

1 So that's why, when we stray from the actual standard
2 here -- let's look at the information they're saying should
3 have been disclosed. Let's look at the total mix of
4 information available. And would this have a significant
5 impact? Is there a substantial likelihood that the failure to
6 disclose this information would have had a significant impact
7 on that reasonable shareholder in making their investment
8 decision?

9 So if we move into dilution -- same problems.
10 Where's the evidence as to what the total mix of information
11 available was?

12 We know that they fully disclosed the diluted
13 information. That's why we went through with Ms. Charles,
14 What's this information in here under FAS 123? Why do we have
15 average number of -- average exercise price? Average life of
16 outstanding options? Number of options?

17 So if we're going to try to change this into a
18 dilution case, let's be clear on it; but the case they alleged
19 and the case they described in their trial brief has failed.

20 **MS. LAMARCA:** Your Honor, may I respond?

21 **THE COURT:** Certainly.

22 **MS. LAMARCA:** First, we did have evidence about how
23 important this was to investors.

24 Now, this further question --

25 **THE COURT:** What's the evidence?

1 **MS. LAMARCA:** Among others, the ISS evidence that
2 they didn't want a plan that allowed anybody to grant shares at
3 below fair market value. And that they rewrote their plan to
4 deal with this issue.

5 Beyond that, I think that it is a mis -- a
6 misstatement of the law to suggest that there has to be
7 evidence about how an investor uses this.

8 I think that the jury can draw inferences from the
9 facts and make their own judgment about how investors used this
10 information.

11 But, to move on, I think the other part of this is:
12 even if -- even if we were to go down the road of other parts
13 of the 10-K had information that investors could have relied on
14 instead of the earnings and instead of this statement that
15 said, you know, "We don't grant it below fair market value,"
16 which is what I understood Counsel's argument to be just now --
17 even that from Betty Jo Charles' testimony was not accurate.
18 We went through with her how the outstanding options was not an
19 accurate number. So those other numbers -- if they -- you
20 know, to the extent they --

21 **THE COURT:** How the outstanding options were --

22 **MS. LAMARCA:** The number of options outstanding at
23 the end of a period is a number that is reported by the
24 company.

25 **THE COURT:** Okay.

1 **MS. LAMARCA:** I think it has been the argument of the
2 defense that the number of options outstanding, if that's
3 reported, then one can somehow estimate or derive what the,
4 quote, "value" of options would be. I think that's what we're
5 going to hear that from Mr. Lehn.

6 And Ms. Charles laid the factual groundwork for that
7 number, itself, being inaccurate.

8 So I didn't want to go down that road. That's not
9 our materiality case, but I just wanted to set the record
10 straight that these things are not part of the vast facts about
11 what really was disclosed and a failure of proof on our part
12 about what was not. It is clear that there was a GAAP
13 violation; but in addition, there was also a pure and simple
14 false statement. And both of those things are impactful. Both
15 of these things are significant to investors.

16 **THE COURT:** It's now 8:30. I want to hear your
17 response on the knowledge question.

18 **MS. LAMARCA:** Sure.

19 **THE COURT:** What evidence was there in your case in
20 chief that Mr. Pattison knew what APB required, in fairly clear
21 terms?

22 **MS. LAMARCA:** Okay. Let me state for a moment I'm
23 not sure that the defendant has to know in clear terms what
24 APB 25 states, but we do have -- we do have evidence that the
25 defendant, himself, had that information first at his

1 fingertips as an accountant. As a CPA, those are the rules he
2 deals with.

3 Second, he received, as early as 2001, an e-mail from
4 a fellow named Richard Cain. And I'm actually forgetting the
5 exhibit number. It's cited in our brief, I believe. And he
6 also worked with the professionals at Pricewaterhouse, quarter
7 after quarter. And he understood the actual language in the
8 10-K that he helped put together. He, himself, was preparing
9 the FAS 123 numbers. And he was preparing the APB bit, as it
10 was described by the --

11 **THE COURT:** Is there testimony that he prepared the
12 APB -- you mean, the note?

13 **MS. LAMARCA:** No. The portion of the disclosures
14 that had to do with APB 25, and the portion of the financial
15 statement, itself, that had to do with APB 25 calculations.
16 That came from Eddy Jackson's testimony.

17 I'm sorry. I could go on. I just need a moment.

18 We had testimony from Ms. Haberberger about her
19 receipt of these numbers from the defendant.

20 **THE COURT:** Well, there's no question that the --
21 that there's testimony that, you know, he was responsible for
22 the numbers, for rolling it up, providing the numbers,
23 reporting the numbers, et cetera, et cetera.

24 **MS. LAMARCA:** Right.

25 **THE COURT:** This case ultimately is going to turn, in

1 part, upon the jury's determination about his either
2 recklessness or purposefulness.

3 (Reporter interruption)

4 **THE COURT:** Willfulness.

5 **MS. LAMARCA:** If I could make an analogy, your Honor,
6 if we had a case right now against -- let's take somebody who's
7 not the top accountant. He's the CEO. And we had evidence
8 that the CEO, himself, had a hand in these numbers, and that
9 the CEO, himself, did this same sort of backdating. We would
10 have a case for fraud against that CEO, even though we don't
11 have to prove in that case and wouldn't likely have information
12 showing that he, himself, is reading APB 25.

13 **THE COURT:** Well, yeah, but you'd have to show
14 something from which a jury can infer that the CEO had enough
15 knowledge to know that the reporting aspect was wrong.

16 **MS. LAMARCA:** Correct. And some of that information
17 is the defendant's own role in being the top accountant at the
18 company; being the person who interfaces on a quarterly and
19 annual basis with the accountants about this very fact.

20 And so for -- two things can be drawn from that.

21 One: He doesn't tell those accountants what he's --
22 how he's really doing it. So the evidence is that he is
23 avoiding telling them that, and that is a perfectly fair
24 inference from this record.

25 We have all kinds of documents that describe the

1 grant date, and documents that he helped author, including the
2 financial statements, that talk about what happens on the date
3 of grant. And nothing happened on that date. And that was an
4 important piece of information he needed to tell the
5 accountants -- he knew that -- if he was going to explain what
6 he was doing.

7 **THE COURT:** That's the question. That's the
8 question: Whether he knew it was important enough to tell the
9 accountants. I mean, I'm not necessarily -- I'm just saying
10 that's the question. That is the question.

11 No question he did these things. At least, there's
12 testimony as to that.

13 The question is: Did he know it was significant
14 enough, such that he should have told them? Or can the jury
15 infer that, based on his training and everything else, he knew
16 full well, and he was, you know, hiding the ball.

17 **MS. LAMARCA:** Yes. And, in fact, I think the other
18 testimony that helps us in that regard was the testimony from
19 the auditors, who thought this was not difficult; Mr. Jackson,
20 in particular. And some of that testimony was elicited on
21 cross-examination as well.

22 **THE COURT:** All right. Let me just hear a quick
23 response.

24 **MR. RICHARD:** Sure, your Honor. Mr. Macaulay is
25 addressing the intent issues. I don't want to step on his

1 toes. Doesn't look like we're going to conclude this
2 discussion at this point.

3 **THE COURT:** Well, I'm likely to take this under
4 submission, but I want to hear --

5 **MR. MACAULAY:** One thing that just jumped out from
6 what the SEC has just mentioned. And that is: They can't
7 establish a primary violation. Just right off the top, they
8 mentioned Stephen Wong; if he was a CEO, we would need some
9 proof that he knew what he was doing.

10 And what he just highlighted -- what the government
11 has just highlighted that they have absolutely no evidence
12 whatsoever of a primary violation by somebody else.

13 Now, this is a slightly different take on some of the
14 things we've been discussing. Goes to the two aiding and
15 abetting claims.

16 **THE COURT:** Mm-hm.

17 **MR. MACAULAY:** Number two and four.

18 There was a total failure of proof as to what
19 Mr. Sabhlok knew; whether he had a knowing violation that
20 would, therefore, create the primary violation for which
21 Mr. Pattison could be aiding and abetting; or that Mr. Wong,
22 likewise, had any knowing violation of 10(b)(5), or false
23 filings, because, if you contrast them to Mr. Pattison, the
24 only thing they really have to say about Mr. Pattison: Well,
25 he was a CPA. That's what they hang their hat on here. He's a

1 CPA; he ought to have known.

2 **THE COURT:** Well, and also he's the one who dealt
3 very closely with the auditors in drafting the narrative, et
4 cetera, et cetera.

5 **MR. MACAULAY:** Sure, but where is there, anywhere, a
6 piece of evidence saying, "What you are doing is wrong"?

7 **MS. LAMARCA:** Your Honor.

8 **MR. MACAULAY:** Please let me finish.

9 **THE COURT:** Let him finish.

10 The closest they can come is a
11 Friday-night-at-midnight e-mail with an 80-age presentation
12 that was sent by someone on -- the tax lawyer. And in there it
13 even said,

14 "Measurement date equals grant date in
15 most cases."

16 The Court in *Shanahan* was looking at the same kind of
17 thing, and saying,

18 "No, you cannot get intent from this
19 kind of metaphysical distinctions."

20 The Court went through those very same arguments as
21 the SEC is making here, and saying,

22 "No, there's not enough. You're going
23 to need to do more."

24 Now -- so that's the one presentation.

25 The mere fact that he's a CPA -- that doesn't get

1 them anywhere. It's like saying to a lawyer, "Well, you've got
2 a license to practice law. Well, that means you must know
3 everything about trusts and estates and divorce law and
4 securities law."

5 **THE COURT:** Well, that's a little disingenuous,
6 because he actually wrote -- I mean, it's clear certainly
7 enough for the jury to -- to infer that he had a hand in
8 writing the notes in terms of, you know, in reference to the
9 accounting policies and in reference to actual APB 25 in the
10 10-Ks. So it wasn't like as if there was some admiralty lawyer
11 not knowing something about ERISA or something. This is
12 something he wrote. It's something he knew about. It's
13 something that pertained. So --

14 **MR. MACAULAY:** There's no actual evidence he wrote
15 it.

16 **THE COURT:** I'm just saying that there's evidence
17 enough that -- from which they could infer. And from that, if
18 they infer that, then they can infer he knew more than
19 you're --

20 **MR. MACAULAY:** All right, but we're getting fairly
21 attenuated.

22 **THE COURT:** Well, it's what a reasonable juror --

23 **MR. MACAULAY:** That's not substantial evidence. And
24 to say Ms. Haberberger, the closest she can come -- "Well, I
25 don't know where all of this language came from. It must have

1 come from Mr. Pattison" -- that someone would cut and paste
2 from some other filing -- well, potentially we don't even have
3 any evidence of that. That doesn't make them aware. That
4 doesn't show actual knowledge.

5 **THE COURT:** All right.

6 **MR. MACAULAY:** Merely touching a 90-page restatement.

7 **THE COURT:** Okay. We're --

8 **MR. RICHARD:** May I suggest that when we resume the
9 discussion, we distinguish between standard of care under
10 recklessness, as other courts have done, and then *scienter* and
11 actual knowledge, which I took to be your -- I think we're
12 going to end up having that distinction as we go forward.

13 **THE COURT:** Let me ask your response about the
14 failure to prove on Wong and Sabhlok. What's the evidence if
15 you have to prove a primary violation for aiding and abetting?
16 Don't you have to show --

17 **MS. LAMARCA:** Sure. Yes. And here we do have proof
18 on Wong and Sabhlok. And, in fact -- and the Sabhlok proof
19 actually goes to Mr. Pattison's mental state as well.

20 So what we do have is -- this is just sort of very
21 plain, easy evidence. Mr. Ferruolo sent a response to an
22 e-mail from Mr. Sabhlok.

23 "Can we grant options retroactively?"

24 "No, absolutely not."

25 The parties have a telephone call that day. And the

1 parties were Mr. Wong -- Mr. Sabhlok, Mr. Pattison, and
2 Mr. Ferruolo. And there's plenty of evidence from which the
3 jury finds that.

4 **THE COURT:** That was 2004, as I recall.

5 **MS. LAMARCA:** Yes. And so --

6 **THE COURT:** Were there grants in question made after
7 that phone call?

8 **MS. LAMARCA:** There were grants made days -- that
9 were put into the process of being "born" as grants, so to
10 speak, in the first week of October. And this is two weeks
11 later. And days later, Mr. Pattison makes sure those grants
12 are finalized by Ms. Cerles.

13 And then months later -- two months later -- he makes
14 sure that those financial statements -- both Mr. Wong and -- I
15 mean, Mr. Sabhlok and Mr. Pattison make sure that those
16 financial statements failed to include the compensation expense
17 associated with those, and that they also do not disclose that
18 they had been backdating, notwithstanding that they know that
19 they cannot do so.

20 **THE COURT:** Okay. What about Mr. Wong?

21 **MS. LAMARCA:** And Mr. Wong -- the evidence about
22 Mr. Wong's conduct is best, I think, put in light of: He was
23 doing this. He was actively involved in it and, at the end of
24 day, he kept silent about it. That evidence, although it's
25 after Mr. Pattison's time, is still highly indicative of

1 Mr. Wong's consciousness of guilt.

2 **THE COURT:** All right. I'm going to take the matter
3 under submission.

4 **MS. LAMARCA:** Okay.

5 **THE COURT:** And what we will need to talk about -- I
6 mean, you've filed extensive briefs. I will reread the briefs
7 with cases; but what we will need to talk about are jury
8 instructions, which I don't want to do right now. Let's take
9 that up maybe at the lunch break or something.

10 **MR. RICHARD:** Thank you, your Honor.

11 **MS. LAMARCA:** Thank you.

12 **THE COURT:** Thank you.

13 (Jury in at 8:42 a.m.)

14 (The following proceedings were held in open court,
15 in the presence of the Jury:)

16 **THE CLERK:** Please be seated.

17 **THE COURT:** Okay. Good morning once again. I
18 apologize for the slight delay. We had some legal matters to
19 take care of. We are now ready to resume and pick up where we
20 left off yesterday, which was the continued cross-examination
21 of Mr. Pattison.

22 **MR. TASHJIAN:** Thank you, your Honor.

23 (Defendant resumes stand.)
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MICHAEL PATTISON,

called as a witness for the Defendant herein, having been
previously sworn and testified, resumed the stand and testified
further as follows:

CROSS-EXAMINATION, RESUMED

BY MR. TASHJIAN:

Q. Good morning, Mr. Pattison.

A. Good morning.

Q. When you started at Embarcadero, the company was already
preparing for its IPO in 2000. Is that fair to say?

A. If they hadn't started, it was very close.

Q. Embarcadero went public in April of 2000. Is that right?

A. Yes.

Q. And you started a few months before that?

A. Right.

Q. The company's stock did very well after its IPO. Is that
fair to say?

A. I believe it did, yes. I remember the initial periods.

Q. The initial periods through the end of the year 2000 --
during that period, Embarcadero was one of the top-performing
IPOs of the year. Is that right?

A. I can't remember that. I'm thinking, like, the first day.
It was up \$4 the first day.

Q. At what price did it go public: 10 or 15?

1 **A.** \$10.

2 **Q.** And by the end of the year, it had hit highs of about \$60.
3 Is that right?

4 **A.** I think it got to 60. I don't know when.

5 **Q.** Is it fair to say that when you were thinking about
6 joining Embarcadero, that you didn't go there for the salary
7 the company was going to pay you? Is that a fair statement?

8 **A.** No. I think I did go there for the salary.

9 **Q.** Okay. Your attorney, in his opening statement, said
10 something about your first-year starting salary. Do you recall
11 that?

12 **A.** Right.

13 **Q.** And in addition to your salary, your total compensation
14 was more than that. Is that right?

15 **A.** Well, it was. I mean, I did have stock options, but I
16 mean, the fact was, you know, a starting controller isn't going
17 to make a lot of money. So I don't think I was underpaid for
18 the job I had with my salary alone.

19 **Q.** Okay. Well, let's take a look at -- at some of those --
20 the stock options. If we could, pull up Exhibit 655 first,
21 which is already in evidence. It's the Equity Edge database
22 report. And if we look down to the P's, I think it starts on
23 page -- could be on page 22. There, according to the
24 Equity Edge report, it looks like you've got -- you received
25 three stock option grants that were dated prior to April 2000.

1 **A.** Right. About half the options, I was -- I received while
2 I was there.

3 **Q.** So over the course of your employment at Embarcadero,
4 about half of your options came before you start -- before the
5 IPO or dated before the IPO. Is that right?

6 **A.** I think generally that's correct, yes.

7 **MR. TASHJIAN:** And if you look at those grants -- and
8 in particular, we're looking at one that's dated June 30th,
9 1999. It's the top one on the Mr. Pattison's list, if you
10 could highlight that.

11 **BY MR. TASHJIAN:**

12 **Q.** Do you see that?

13 **A.** Yes, I do.

14 **Q.** June 30th.

15 And then there's one dated January 4th, 2000. Do you see
16 that?

17 **A.** Yes.

18 **Q.** And then there's a third one that's dated March 22nd,
19 2000. That was just about a month or so -- the month prior to
20 the IPO. Is that right?

21 **A.** Right. Stephen granted options to everyone in the company
22 on that date.

23 **Q.** The options that are dated in 1999 -- were those granted
24 to you when you did a little bit of consulting work for the
25 company?

1 **A.** Exactly. They were thinking about being acquired by
2 another company, so I helped Stephen pull together some of the
3 documents.

4 **Q.** And that was before you became the controller?

5 **A.** Yes.

6 **Q.** And you were doing -- you were on a consulting agreement.
7 Is that right?

8 **A.** I think it was an envelope consulting agreement.

9 **Q.** Okay.

10 **A.** I don't think there was an actual agreement.

11 **Q.** The January 4th, 2000, options -- those were the
12 equivalent of your new-hire options. Is that fair to say?

13 **A.** Yes.

14 **Q.** And then the once that are dated March are just, as we
15 said, just slightly before the IPO?

16 **A.** Right. And Stephen, you know, kind of granted to the
17 whole firm.

18 **Q.** Now, we've heard a lot about a vesting period of options.
19 Those three grants invested over time. Is that right?

20 **A.** That's right.

21 **Q.** So it meant you couldn't exercise them right away. You
22 had to wait a period of time during your employment before you
23 could exercise those options?

24 **A.** Correct.

25 **Q.** And before the company's IPO in April 2000, Embarcadero

1 stock wasn't listed on a -- on a stock exchange, right?

2 **A.** No.

3 **Q.** It wasn't?

4 **A.** It --

5 **Q.** I'm sorry. I asked the question. I just want to make
6 sure --

7 **A.** Sorry.

8 No, it was not.

9 **Q.** It was not.

10 So the -- in order to come up with the exercise price for
11 those options, the Board made that determination. Is that fair
12 to say?

13 **A.** I'm not quite sure. The Board -- I guess the Board did,
14 but it was subject to review through the IPO process, I guess,
15 would be the best way to say it.

16 **Q.** What do you mean by that?

17 **A.** It was my understanding that, you know, we talked a little
18 bit about cheap stock; that oftentimes when companies were
19 going public, the auditors would ask about, you know, the
20 historical pricing, and then do a look-back, to see if they
21 were adequate, and really kind of mapped to, you know, a
22 reasonable range of prices, as compared to, you know, a
23 hypothetical value of the company.

24 **Q.** Okay.

25 **A.** So the Board granted it without knowing what the company's

1 value really would be, because they didn't have any evidence,
2 because it wasn't traded. So then, you know, collaboratively,
3 the firm and PwC and the underwriters went back and just tried
4 to pick subjective dates to get, you know, maybe a better
5 measurement date, so to speak.

6 **Q.** So, in other words, the Board and the company couldn't
7 look to stock market on the date of grant to figure out what
8 that fair market value was. It had to -- the Board had to make
9 its best judgment. Is that right?

10 **A.** Right.

11 **Q.** And then, in retrospect, as the company led up to its IPO,
12 there was a look-back process to see whether those best
13 judgments sort of corresponded to where the market was. Is
14 that a way to say it?

15 **A.** You know, having just spent my only IPO, that, I think, is
16 a general way. I mean, everybody was very familiar with the
17 process at the time. So --

18 **Q.** And you've referred to this term called "cheap stock" or
19 "cheap stock charge," right?

20 **A.** I think that's the -- you know, the underwriting
21 vernacular. I don't know where it came from.

22 **Q.** All right. So, in retrospect, as the company looked back
23 in time as it went up to the IPO, it determined that the
24 exercise price was less than the fair market value on the date
25 of grant? Is that essentially what happened?

1 **A.** I believe so, yes.

2 **Q.** And the company took a charge over time for that
3 difference in the value? Is that right?

4 **A.** That's right.

5 **Q.** And that's what's referred to as the "cheap stock charge"?

6 **A.** Yes.

7 **Q.** And, as the controller, you helped prepare the
8 amortization of that charge over the next three or four years.
9 Is that right?

10 **A.** I recorded the amortization. I didn't help prepare it.

11 **Q.** Meaning that a calculation of the charge was done by
12 somebody else. Is that right?

13 **A.** Correct.

14 **Q.** But you knew what the amortization was. You had that
15 schedule, right?

16 **A.** Exactly.

17 **Q.** Then you applied that amortization schedule to the charge,
18 and took those expenses over time. Is that right?

19 **A.** Well, the schedule kind of mapped out the amortization
20 over the life of the options, so it was well defined in
21 quarterly columns.

22 **Q.** I guess that's all a long way of saying that for the three
23 pre-IPO stock options that you received -- those three
24 grants -- the company ended up taking an expense for those. Is
25 that fair to say?

1 **A.** No, I don't think so, because the March 22nd was actually
2 higher than the IPO price. So I would say that that was not
3 the case on that one.

4 **Q.** Oh, I see. So the March 22nd, 2000, grant was priced at
5 \$12 a share. Is that right?

6 **A.** Right.

7 **Q.** That was higher than the IPO price?

8 **A.** Right.

9 **Q.** So the company didn't take a charge for that particular
10 grant?

11 **A.** I can't say that, but based on what we just discussed, I'm
12 assuming they did not.

13 **Q.** Okay. The other 12 grants -- the 1999 grant and the
14 January grant -- is it fair to say the company took a charge
15 for those -- for those stock options?

16 **A.** It's fair to say that.

17 **Q.** Now, you were employed at Embarcadero through August --
18 the beginning of August 2005. Is that what you said?

19 **A.** I think it was July or August. I don't remember.

20 **Q.** We'll call it "mid 2005."

21 **A.** Okay.

22 **Q.** So over the next five and a half years, is it fair to say
23 that you exercised some of these stock options?

24 **A.** I did.

25 **Q.** And by -- when you exercised the stock options, it meant

1 you paid the exercise price. Is that right?

2 **A.** Yes.

3 **Q.** And that meant you bought the shares at that price.

4 And then you sold the shares at the prevailing market
5 price. Is that right?

6 **A.** Right.

7 **Q.** And your -- the profits or the proceeds that you made
8 would be the amount that you sold the shares for, less the
9 amount that you paid to exercise the options?

10 **A.** Yes.

11 **Q.** And you did that for the -- for these pre-IPO stock
12 options as well? It's fair to say that?

13 **A.** I did. I don't know to what extent. And then those would
14 be considered wages.

15 **Q.** So you paid taxes on them?

16 **A.** Right.

17 **Q.** Now, in order for you to exercise your stock options, were
18 you -- like the other employees at Embarcadero, did you have an
19 E*Trade account that you did that?

20 **A.** I did.

21 **Q.** So you would go onto your E*Trade account and place your
22 order to do that. Is that right?

23 **A.** I did. I mean, there was a period of time where E*Trade
24 wasn't set up. We had a lot of difficulty getting all of the
25 information loaded. And we -- I don't think we contracted with

1 E*Trade until maybe July of 2000. So there was a period of
2 time where it was actually being done manually, but for most of
3 the time say, after, you know, 2000, it was done via E*Trade.

4 **Q.** Okay. And E*Trade took the exercise information and the
5 sale information, and put that information into the Equity Edge
6 database. Is that right?

7 **A.** Yes.

8 **Q.** And, as controller, you had access to that Equity Edge
9 database. Is that fair to say?

10 **A.** Yes.

11 **Q.** And you would use that exercise information as part of
12 your routine part of your job. Is that right?

13 **A.** On a quarterly basis, yeah. I mean, it -- it affected the
14 outstanding stock options.

15 **Q.** Sure. And that was some of the information that you had
16 to provide to the auditors, too, right?

17 **A.** Yes.

18 **MR. TASHJIAN:** Could we pull up Exhibit 657, which is
19 in evidence? At the very top of Exhibit 657 -- scroll down a
20 little bit, Mr. King.

21 **MR. MACAULAY:** Is this in evidence?

22 **MR. TASHJIAN:** Yes.

23 **THE COURT:** Well, let's see.

24 **THE CLERK:** Yes, yes.

25 **MR. MACAULAY:** Okay. Thank you.

1 **MR. TASHJIAN:** I need to see the very top line. It
2 says, "Stock Options Exercised." There we go.

3 **BY MR. TASHJIAN:**

4 **Q.** It says, "Stock Options Exercised." Did you have
5 access -- you had access to reports like Exhibit 657 in the
6 course of your employment at Embarcadero. Is that fair to say?

7 **A.** I did. Yes.

8 Is this supposed to be a complete document, or is it just
9 mine, or --

10 **Q.** It is an excerpt from a fuller report.

11 **A.** Yeah. It starts at page 74.

12 **Q.** That's right. The exhibit starts at page 74.

13 **A.** Okay.

14 **Q.** But it reflects, I believe -- and we can go through
15 this -- exercise data for your stock options.

16 **A.** Okay.

17 **Q.** So do you see your name there on the "Name" column?

18 **A.** I do.

19 **Q.** And then above your name there's a number. Do you see the
20 number on the first page of the exhibit is 254? Do you see
21 that?

22 **A.** Okay. I do.

23 **Q.** That refers to a grant number that Equity Edge assigned to
24 each one of your grants?

25 **A.** Okay.

1 Q. And all -- I mean, Equity Edge assigned to all grants in
2 the database a number; a grant number. Is that right?

3 A. I believe so. Yes.

4 Q. So the first three pages of Exhibit 657 reflect exercises
5 for -- that you made for that particular grant: 254. Is that
6 fair to say?

7 A. It appears so, yes.

8 So this first one is the one in 1999.

9 Q. That's right. So exhibit -- I mean, Grant Number 254
10 reflects your June 30th, 1999, stock options. Is that right?

11 A. Yes.

12 Q. And you can -- you can tell also because, if you look over
13 on the column, if you scroll over to the right, you'll see a
14 price.

15 A. Yeah. That's what I -- that's what helped me.

16 Q. Okay. The 25-cent price there in the first column -- that
17 was the exercise price for each one of the shares in the 1999
18 grant. Is that right?

19 A. Yeah, I believe so.

20 Q. And then the total price is the amount that you paid.
21 It's the number of shares -- the 417 shares -- times the
22 exercise price equals the total price? That's what you paid to
23 exercise that particular chunk of shares? Is that fair to say?

24 A. I haven't looked at these reports in a long time. I don't
25 have a calculator. I'm very -- I would assume that that is

1 correct, yes; but I'm not sure if I'm supposed to be
2 recalculating these. I think the total price would be the
3 total price I paid, but I really haven't seen these documents
4 in a long time. So --

5 **Q.** The value basis column -- it's \$16.82. That's just the
6 entry in the first column, but the numbers that are reflected
7 in that column reflect the market price that you ended up
8 selling the shares at. Is that fair to say?

9 **A.** Again, I -- I guess it is. I don't -- I don't remember
10 how this schedule works.

11 **Q.** Okay. That's fair.

12 **A.** It would look that that's the total value. And then, as
13 you just described -- and then we would take the total price.
14 And the difference would be, you know, the wage.

15 **Q.** The wage that --

16 **A.** Right.

17 **Q.** And that's the tax deduction over there \$6,909?

18 **A.** Exactly.

19 **Q.** And that's the tax deduction to Embarcadero. I mean,
20 those are Embarcadero records. That's the tax deduction
21 Embarcadero would take for, essentially, the profits from that
22 particular exercise?

23 **A.** Right.

24 **Q.** But that six -- the \$6,909 number -- that reflected also
25 for -- from your perspective, the total proceeds from that

1 exercise and sale? Is that fair to say?

2 **A.** I think that's fair. Yeah.

3 **Q.** And if you totaled up, as we go down the page, each entry
4 where you see your name on the --

5 **MR. TASHJIAN:** If you could scroll over, Mr. King --

6 **BY MR. TASHJIAN:**

7 **Q.** Each entry where we see your name is a different date that
8 you exercised portions of this particular grant: 254. Is that
9 fair to say, too?

10 **A.** I think so. Are these grants in question, too?

11 I don't even -- I don't know what the ultimate outcome of
12 the whole investigation was. Is there a problem with that
13 pre-IPO one as well -- the 99?

14 **Q.** Well, what I'm interested in is the amount of money that
15 you ended up exercising and selling these pre-IPO shares for.

16 **A.** Okay.

17 **Q.** Is it fair to say that we could derive the amount of money
18 that you made from these Equity Edge reports if we totaled up
19 the total number of exercises in your gross proceeds for each
20 one of the pre-IPO stock options?

21 **A.** That's something that I'm not going to speculate on. I
22 mean, if that's the research you've done, then that's the
23 answer; but I'm not going to comment on that.

24 **Q.** Well, let me put it this way. Is it fair to say that for
25 the three grants -- the three IPO grants that -- for the 199 --

1 I'm sorry -- for the 1999 stock options, that your total
2 proceeds from those 2000 shares totaled about \$80,000?

3 **A.** That's what this report, you know, reflects.

4 I mean, it would be easier if we just looked at my W-2 and
5 saw it on there or something; but I mean, I never really used a
6 report like this for me individually.

7 I think there's another report that shows -- you know,
8 that better reflects it; that -- and that's the one that I used
9 to pass out to the employees, you know, or via Nichole, or
10 actually maybe E*Trade even mailed it to them as a part of
11 their W-2 package.

12 So I -- I do recall this report. I used to run this just
13 to get the information for -- not so much for the total value
14 or the total price or the total deduction, but what quantity of
15 shares were exercised in a given point so it could go into the
16 stock option roll-forward.

17 **Q.** Okay.

18 **A.** And we did use the total price column to provide evidence
19 to PwC that the funds were actually hitting the bank account,
20 because that was one of their tests.

21 **Q.** So --

22 **A.** So that was the extent of my work with this document.

23 **Q.** No. That's fair enough.

24 I'm asking for your -- your best recollection and whether
25 it's consistent with these reports that for the 1999 shares,

1 that you exercised them over -- over the next five years?

2 **A.** Yeah. That's what I was going to say. I mean, it wasn't
3 all at once.

4 **Q.** It wasn't all at once?

5 **A.** No.

6 **Q.** And is it fair to say that you made about \$80,000 from
7 those 1999 shares?

8 **A.** If you look at this schedule, that's what totals in that
9 tax deduction column. Again, I've never looked at this
10 schedule, you know, for that purpose, so I don't want to
11 speculate as to what that means.

12 **Q.** Is -- if we looked at the next grant, the grant that was
13 dated January 4th, 2000, I think that those options were
14 numbered 274. Is it fair to say that you made approximately
15 \$290,000 from those options over time?

16 **A.** I don't know. I don't want to speculate on that. I mean,
17 that's what this -- I don't even see that amount on this.

18 **Q.** If you turn to page 98 on the report, you'll see a total
19 value number and a total price number. The total value is
20 \$308,000. The total price that you paid was \$18,700?

21 **A.** Okay. Well, why isn't there an amount in the
22 tax-deduction column, like on the first one?

23 **Q.** I'm not a tax expert, Mr. Pattison; but I would surmise
24 that perhaps the company couldn't take a tax deduction for
25 those particular --

1 A. Oh, okay.

2 Q. -- options.

3 A. Well, that's why I don't want to speculate as to what
4 these reports say.

5 Q. That's fair enough.

6 And from the -- that third tranche of options that were
7 dated in March -- you exercised those as well. Is that fair to
8 say?

9 A. Over the course of my employment. I think that's fair to
10 say.

11 Q. Is it fair to say that you made about \$80,000 from those
12 options as well?

13 A. I can't say. We could look at my payroll records. That
14 would probably be a much more defining report.

15 Q. Well, I've got to say we do have copies of your W-2, but
16 I'm not sure that we really need to get those into evidence.

17 A. Okay.

18 MR. TASHJIAN: If we could go back to Exhibit 655 and
19 look at the Pattison -- there we go.

20 BY MR. TASHJIAN:

21 Q. There are eight lines there. We've gone through three of
22 them. The other five grants were post-IPO stock options. Is
23 that fair to say?

24 A. Yes.

25 Q. So there's one that's dated April 5th, 2001. Do you see

1 that?

2 **A.** Yes, I do.

3 **Q.** One that's dated October 2nd, 2001?

4 **A.** Yes.

5 **Q.** October 17th, 2002?

6 **A.** Yes.

7 **Q.** July 2nd, 2003?

8 **A.** Yes.

9 **Q.** And October 3rd, 2003? Do you see that?

10 **A.** Yes, I do.

11 **Q.** Each one of those grants, is it fair to say, was priced at
12 the low of the respective quarter in which they were dated and
13 priced? Is that a fair statement?

14 **A.** More than likely.

15 **Q.** And you exercised those stock options during the course of
16 your employment, too, didn't you?

17 **A.** That's right, but I mean, that's really, you know, the
18 point of, you know, stock options. So, I mean, it's a part of
19 your compensation package. And if -- if the price goes up,
20 then you sell them.

21 **Q.** Isn't it fair to say that you made approximately \$86,000
22 from the exercises of those grants?

23 **A.** I don't know.

24 **Q.** Would you agree that we could look in the Equity Edge
25 records to figure that out?

1 **A.** I believe we could, yeah; a report better than this one,
2 from my recollection. I know a lot of those were never
3 exercised, so I think maybe a little more than half were
4 exercised out of the total grant.

5 **Q.** I wanted to ask you a little bit more about the
6 October 2nd, 2001, grant, if I could ask you to turn to
7 Exhibit 483 in your binder.

8 **MR. TASHJIAN:** Your Honor, the parties have
9 stipulated Exhibit 483 is an authentic copy of a grant list
10 from Embarcadero.

11 **BY MR. TASHJIAN:**

12 **Q.** Mr. Pattison, do you recognize Stephen Wong's signature at
13 the bottom of the grant list?

14 **A.** I do. That's about all I recognize. Mine is almost
15 impossible to read.

16 **Q.** It's a pervasive problem in this case. I apologize.
17 Do you see -- can you -- if you look at your -- through
18 the P's on the list, do you see your name on the -- on the
19 grant list?

20 **A.** I do.

21 **MR. TASHJIAN:** Your Honor, I'd ask that Exhibit 483
22 be put into evidence.

23 **THE COURT:** Any objection?

24 **MR. RICHARD:** No, your Honor.

25 **THE COURT:** Admitted.

1 (Trial Exhibit 483 received in evidence)

2 **MR. TASHJIAN:** Now everyone gets to suffer.

3 So if we could enlarge -- yes. Keep going. Scroll
4 down, please, to the P's. Difficult to see, but now I've lost
5 it.

6 **BY MR. TASHJIAN:**

7 **Q.** Michael Pattison. 10/2/01. 10,000 shares at \$7.

8 Do you see that, Mr. Pattison?

9 **A.** I do.

10 **Q.** Is it fair to say that \$7 was the lowest closing stock
11 price in the fourth quarter 2001?

12 **A.** Through the course of the investigation, I'm assuming that
13 that is.

14 **Q.** I mean, we could look at the stock price.

15 **A.** I know. I'm just -- if you're telling me, so then I
16 believe it.

17 **Q.** October -- I'm sorry. Seven dollars was the -- well, you
18 were at Embarcadero on -- through the course of the
19 September 11th terrorist attacks. Do you remember that?

20 **A.** Yes, I do, very well.

21 **Q.** And do you recall that the stock market was closed for a
22 period of time after the after the attacks?

23 **A.** I do. And -- yeah, and we closed for a day or two as
24 well.

25 **Q.** And Embarcadero stock, like the rest of the stock market,

1 fell after the market reopened. Do you recall that?

2 **A.** You know, I'm sure it did. I don't recall the specifics.

3 **Q.** Do you recall that October 2nd was the lowest closing
4 stock price through the end of 2001 for Embarcadero?

5 **A.** I don't, but I know it was, you know, Stephen's process to
6 pick the low of the quarter. So going on that, I'm assuming it
7 was.

8 **Q.** Well, let's look at Mr. Wong's significant down at the
9 bottom, if we could scroll down. You see "Approved." And you
10 recognize Mr. Wong's signature, I think you said?

11 **A.** I do.

12 **Q.** There's a date underneath Mr. Wong's signature. Do you
13 see that?

14 **A.** I do.

15 **Q.** It says, "3 Oct. '01." Do you see that?

16 **A.** Right.

17 **Q.** Now, October 3rd was the third day of the fourth quarter
18 2001. Is that right?

19 **A.** Yes.

20 **Q.** Would you say it was not -- it was not the customary
21 practice for Embarcadero to approve or grant stock options on
22 the third day of a quarter?

23 **A.** That's correct.

24 **Q.** Mr. Wong didn't sign this grant list on October 3rd, 2001,
25 did he?

1 **A.** My guess is he didn't.

2 You know, I think you're reading too much into the
3 language around this. There -- we've seen a lot of
4 inconsistencies. I don't think he did. Some had dates. Some
5 had "Approved." Some had "as of." Some had "grant date."

6 You know, I don't think there's a lot of value to looking
7 to the language around his signature. I wasn't looking at
8 that. I was looking at the fact of authorization. So it's
9 somewhat frustrating, because every one we look at looks
10 different. So it's hard for me to really determine exactly
11 what, you know, the intent was, and the literal intent and the
12 literal reading of the words around these. So --

13 But you're right. I don't think he did.

14 **Q.** You spoke yesterday, I believe, about the importance to
15 you of consistency as it came to the financial statements.
16 Isn't that right?

17 **A.** That's right.

18 **Q.** You talked about GAAP applied on a consistent basis?

19 **A.** That's right.

20 **Q.** And you knew, as a controller, that it was important. If
21 there was one thing that was important, it was to be
22 consistent. Is that fair to say?

23 **A.** That's right. And he consistently approved and authorized
24 options every quarter. You know, this -- you can read the
25 language. And the import of some of these words in a literal

1 reading -- I mean, that -- we saw that document the other day
2 or yesterday -- "grants not granted."

3 I mean, it doesn't make any common sense, right? I mean,
4 the language doesn't mean that they were granted but they were
5 not granted.

6 So it's kind of difficult. We look at these words and
7 we're picking up meanings as to what it is. And I just -- I
8 don't think there's any there there, but that's just me. I
9 mean, I wasn't looking at that language.

10 **Q.** Well, let's look at when you sent the October 2nd grants
11 to E*Trade.

12 Could I ask you to turn to Exhibit 495, please?

13 **A.** Sure.

14 You know, and your -- okay. Your point as to the -- the
15 market collapse -- you know, I don't remember. Maybe he said,
16 "This is a good time to buck up morale." I don't know, but
17 clearly it was sent at the end of the quarter.

18 **Q.** If you look at --

19 **MR. TASHJIAN:** Your Honor, Exhibit 495 -- parties
20 have stipulated that it's an authentic copy of the e-mail and
21 attachment that Mr. Pattison sent to E*Trade, dated
22 January 7th, 2002. I guess I would ask that we move it into
23 evidence at this time.

24 **THE COURT:** Any objection?

25 **MR. RICHARD:** No, your Honor.

1 **THE COURT:** Admitted.

2 (Trial Exhibit 495 received in evidence)

3 **THE WITNESS:** I do note as well that I think, you
4 know, in that October one, there were, you know, 250,000
5 options granted on that date, just as a point of interest.

6 **BY MR. TASHJIAN:**

7 **Q.** The subject line is "Fourth Q Grants." Would you agree
8 with me that that refers to the fourth quarter, 2001, grant
9 information?

10 **A.** Yes.

11 **Q.** Were you sending it to E*Trade on January 7th, 2002? Is
12 that right?

13 **A.** We typically sent stuff at the end of the quarter, yes.

14 **Q.** January -- I don't want to argue with you, but you would
15 agree that January 7th is after the end of -- after the end of
16 the fourth quarter?

17 **A.** Yes.

18 **Q.** And, in fact, if you look at the attachment here, if you
19 go to the next page, you'll see that at the top column at the
20 top of the column, it's option date. And those are the 10/2
21 grants -- the 10/2/01 grants. Is that fair to say?

22 **A.** Yes.

23 **Q.** So you'll see -- on the third page, you'll see your name
24 as one of the grantees. The third page of the attachment.
25 There we go. Michael Pattison.

1 Do you see that?

2 **A.** I do.

3 **Q.** Okay. Could I ask you to turn to Exhibit 566?

4 **MR. TASHJIAN:** Your Honor, Exhibit 566 is -- the
5 parties have agreed that it's an authentic printout of an
6 e-mail exchange involving the defendant and Mr. Sabhlok on
7 October 6, 2003. And I'd ask that it of be moved into evidence
8 at this time.

9 **THE COURT:** Any objection?

10 **MR. RICHARD:** It appears to have marginal relevance,
11 your Honor.

12 **THE COURT:** Relevance?

13 **MR. TASHJIAN:** I can ask a question or two, or I
14 could state that it involves stock options to the defendant.

15 **THE COURT:** Well, why don't you ask him questions?
16 And I'll --

17 **MR. RICHARD:** I'll withdraw the objection,
18 your Honor.

19 **THE COURT:** Okay. All right. 566 admitted.

20 (Trial Exhibit 566 received in evidence)

21 **MR. TASHJIAN:** Thank you, your Honor.

22 **BY MR. TASHJIAN:**

23 **Q.** Mr. Pattison, on October 6, 2003, you were still the
24 controller at Embarcadero?

25 **A.** I am.

1 Q. Mr. Sabhlok was the CFO?

2 A. Correct.

3 Q. He was your manager. Is that right?

4 A. That's correct.

5 Q. And he had the -- he had the position of making
6 recommendations about your stock options. Is that fair to say?

7 A. That is correct.

8 Q. So if you look down at the last e-mail in the chain, we
9 see an e-mail from you to Mr. Sabhlok referring to something
10 that -- you wrote,

11 "Walter gave Michael Clarke 3,500
12 options, and you gave him 5,000. Let me
13 know how you want to proceed."

14 Michael Clarke -- now, he was somebody in the financial
15 department. Is that right?

16 A. Yeah. He was the U.K. controller.

17 Q. He was the controller for the U.K. subsidiary?

18 A. That's right. And this is a -- this is a great example
19 of, you know, people using language incorrectly, right? "You
20 gave him."

21 Well, he didn't gave him anything.

22 He was proposing him 5,000 options. And Walter was
23 proposing; but you know, they didn't "give" them to him.

24 Q. "Walter" referred to -- is that Walter Scott?

25 A. That's Walter Scott, who -- you know, the U.K. subsidiary,

1 while it had its books and records, was -- you know, it wasn't
2 an R & D shop. It was a sales and marketing organization. So
3 Walter was involved in the U.K.

4 So Stephen would have said,

5 "Walter, I'm allocating, you know, you
6 to give me a list of people for 50,000
7 options."

8 And so Walter went and allocated.

9 Well, in the meantime, you know, Michael Clarke
10 really reported directly to Raj. So Raj did the same thing.
11 And they doubled it up.

12 **Q.** Oh, I see. So Walter Scott recommended that
13 Michael Clarke receive 3,500 options. And Raj Sabhlok
14 recommended that he get 5,000?

15 **A.** Exactly.

16 **Q.** Okay. And maybe that refers to -- I mean, maybe that
17 explains Mr. Sabhlok's e-mail.

18 "That's crazy. The sales guy giving
19 the accounting guy options. Now that looks
20 good."

21 Do you see that?

22 **A.** That's exactly right.

23 **Q.** And if we scroll up the e-mail chain, there's a little bit
24 of a back-and-forth. Would you agree?

25 **A.** Yes.

1 Q. Okay. Ultimately, you say,

2 "Okay. What should we do with the
3 5,000? Do you want him to have 5 and 3.5
4 both, or redistribute?"

5 What were you referring to?

6 A. Whether Michael was going to get, you know, 5 plus 3.5, or
7 8,500 options proposed, or we were going to get rid of them, or
8 redistribute.

9 Q. And the Michael that you refer to is Michael Clarke?

10 A. Clarke. Correct.

11 Q. Okay. So let's go back up and see, to the top of the
12 e-mail. And we see, "No." And Mr. Sabhlok responds,

13 "No. Let's go with their plan of 3.5K
14 for him, and give the rest evenly to you
15 and Charlie."

16 Do you see that?

17 A. Right.

18 Q. So that is it fair to say that Mr. Sabhlok was saying,
19 "No. Let's give Michael Clarke 3,500 options"? Is that right?

20 A. That's correct.

21 Q. And take the 5,000 that was doubled up, and split it up
22 among you and Charlie? Is that right?

23 A. Right. So he was reallocating the options within the
24 Finance Department pursuant to that.

25 Q. And the "Ann" referred to Ann Roesch. Is that right?

1 **A.** Right; who reported to Raj.

2 **Q.** And Charlie is Charlie Norman?

3 **A.** Yes. Charlie Norman. I don't know how; he had some type
4 of direct line to Raj. He was working on business development,
5 I believe; so that side of Raj's responsibilities.

6 **Q.** So if we divided 5,000 into those 3, you get somewhere
7 around 1,666 shares. Is that right?

8 **A.** .66.

9 **Q.** .66?

10 **A.** Right.

11 **MR. RICHARD:** That clears it up for me, your Honor.

12 **THE COURT:** It's .66667, or something.

13 **BY MR. TASHJIAN:**

14 **Q.** Just to show you what a nice guy I am, Mr. Pattison, I'm
15 going to ask you to turn to Exhibit 201. And you can see the
16 good work that you did.

17 **A.** I thought you were going to say it was larger print.

18 **Q.** No. I can't help you there.

19 Exhibit 201 has already been moved into evidence.

20 There's a grant approval list for the third quarter 2003.
21 It's on page that starts "ETSC1952." I think that these are
22 arranged chronologically.

23 Do you see one that says, "third quarter" from the top --
24 actually, it says "From 1/1/03 to 9/30/03."

25 **A.** And it's a list of, like, 400,000 options.

1 Q. That sounds about right. Yes.

2 A. Okay.

3 Q. 388,000?

4 A. I've got it.

5 Q. If you look -- if we could pull up --

6 MR. TASHJIAN: If we could go to the third page of
7 that list, and blow up the part right -- yeah. So you see
8 "Ann Roesch"? If you can scroll up a little bit, Mr. King.
9 No. I mean, scroll down.

10 BY MR. TASHJIAN:

11 Q. Ann Roesch, Charles Norman, and Michael Pattison. Do you
12 see that?

13 A. Yes, and the rest of the people in the Finance Department.

14 Q. And the rest of the people in the Finance Department.

15 So your option number is 9,166. Do you see that?

16 A. Yes.

17 Q. That reflects the 1,166 options that you split up for --
18 that Mr. Sabhlok recommended be split up for -- from the
19 Michael Clarke pool. Is that fair to say?

20 A. Right. So he must have previously presented 7,500 or
21 something like that, right.

22 Q. Or 8,000, perhaps?

23 A. No. 7,500.

24 Q. 7,500. Okay. I'm sorry. Maybe my math is off.

25 And Charles Norman got 6,666?

1 **A.** Right.

2 **Q.** And then Ann Roesch got 6,668. Do you see that?

3 **A.** Yes.

4 **Q.** You gave the extra one to Ann Roesch. Is that fair to
5 say?

6 **A.** It looks like it.

7 **Q.** Okay. All right. Could I ask you to turn to Exhibit 613
8 in your binder? That, I believe, has already been moved into
9 evidence. It's the workpapers that include the end -- end year
10 of '04.

11 **THE CLERK:** Yes.

12 **BY MR. TASHJIAN:**

13 **Q.** If I could ask you to turn to the page that says, "Equity
14 Cycle Narrative control environment" at the top, it's on
15 page -- one, two, three, four -- it may be the fifth page in on
16 the exhibit.

17 **A.** Okay.

18 **Q.** If we look down at the bottom of that page, there was a
19 date at the bottom in the footer: EMBT equity narr. 12/31/04.

20 Do you see that, Mr. Pattison?

21 **A.** Yes.

22 **Q.** I'm going to ask you a few questions about this particular
23 version of the narrative that ended up in the workpapers.

24 If we turn to the next -- the top of the next page, you'll
25 see that there's a heading that says, "Stock Option Grants."

1 Do you see that?

2 **A.** Yes.

3 **Q.** And then on that -- the following page begins the portion
4 that I'd like to ask a few questions about. So if you turn to
5 the next page. Okay.

6 **MR. TASHJIAN:** If we could scroll up, so we see the
7 paragraph that says -- no. I'm getting my ups and my downs
8 mixed up. The portion that says, "The controller records stock
9 option grant information quarterly in E*Trade."

10 **BY MR. TASHJIAN**

11 **Q.** (Reading)

12 "The controller records stock option
13 grant information quarterly in E*Trade
14 based on the CEO approved list and
15 Comp Committee minutes."

16 Do you see that Mr. Pattison?

17 **A.** Yes.

18 **Q.** The approved list -- is that fair to say that that
19 reflects a list similar to those grant approval summaries that
20 we've been looking at?

21 **MR. RICHARD:** Objection. Lacks foundation as to this
22 document. It's not clear about whether he's asking about the
23 words or this particular document. I think it's somewhat
24 misleading, without laying a foundation for this witness and
25 this particular version, as Counsel referred to.

1 **THE COURT:** Why don't you go ahead and lay a
2 foundation?

3 **MR. TASHJIAN:** Okay.

4 **BY MR. TASHJIAN:**

5 **Q.** Mr. Pattison, you were -- 12/31/04, you were still the
6 controller at Embarcadero?

7 **A.** I was.

8 **Q.** You were -- you've testified a little bit, at least, about
9 your work on the Equity Narrative Cycles. Is that fair to say?
10 Equity Cycle Narrative?

11 **A.** It is fair to say. Earlier on, I think I was more
12 involved than later; but it's fair to say I did work on it.

13 **Q.** You knew that there was a version of the Equity Cycle
14 Narrative that was going to go to PwC at the end of the year.
15 Is that fair to say?

16 **A.** Absolutely.

17 **Q.** You worked with PwC to show them the Equity Cycle
18 Narrative. Is that fair to say?

19 **A.** Earlier on, but you know, then the work kind of got parsed
20 out. And, you know, different priorities took over; at least,
21 for me.

22 **Q.** You're not saying you had nothing to do with the version
23 of the Equity Cycle Narrative that appears in Exhibit 613, are
24 you?

25 **A.** I think I could say that pretty closely to the final

1 version. Yes, I would say that.

2 **Q.** You would say that you didn't have anything to -- let me
3 make sure I understand what you're saying. You're saying you
4 didn't have anything to do with this version?

5 **A.** I think that's fair to say. I mean, there --

6 **Q.** Let me -- could I ask you some questions about whether the
7 description of the process that appeared in the PwC workpapers
8 was consistent with your understanding of how the process
9 worked at the time when you were the controller from 2000
10 through the end of 2004?

11 **A.** Okay.

12 **Q.** So the portion I'm asking you about says,

13 "The controller records stock option
14 grant information quarterly in E*Trade
15 based on the CEO approved list and the
16 Comp Committee minutes."

17 You sent information to E*Trade about the grants.
18 We've talked about that. Is that right?

19 **A.** Yes.

20 **Q.** You've also talked about the preparation of the grant
21 approval summaries that Mr. Wong had signed?

22 **A.** Yes.

23 **Q.** Is that fair to say?

24 And you also collected and aggregated the information from
25 the stock option grants that the Compensation Committee

1 approved. Is that right?

2 **A.** Yes. I mean, I -- I -- every quarter, I collected the
3 Board and committee meeting minutes for the auditors, so I
4 would review them at that time or whenever they were sent over
5 to me.

6 **Q.** And, if we could skip down two paragraphs, it says,

7 "On a quarterly basis the controller
8 prepares the option activity worksheet
9 containing the new-hire authorized stock
10 option grants in the quarter, and the
11 authorized performance bonus stock award
12 option grants in an Excel workbook."

13 So we've heard testimony about how you prepared the --
14 the -- I'm sorry.

15 There were these lists that were prepared that
16 Stephen Wong signed. Is that right?

17 **A.** Yes.

18 **Q.** And those reflected the new-hire stock option grants. Is
19 that right?

20 **A.** I think this is somewhat of a new process, actually. I
21 don't remember them being on different lists. You know, if you
22 look back at the quarterlies we were looking at, they were all
23 on one list. So I think this is a new process from SOX.

24 **Q.** Well, you wouldn't dispute the fact that Nichole Cerles --
25 Miss McKenzie -- kept track of the new hires during the

1 quarter, and provided you with that information at the end of
2 each quarter, from 2000 through the end of 2004?

3 **A.** Yeah. That's correct.

4 **Q.** And you wouldn't dispute that there were -- there was an
5 aggregation of all of the managers' recommendations for the
6 performance grants. Is that fair to say?

7 **A.** Yes.

8 **Q.** And that you put those two lists together to send to
9 Stephen Wong for his approval. Is that right?

10 **A.** Yes.

11 **Q.** The sentence at the very bottom of the page says,

12 "The controller forwards the option
13 activity worksheet to the CEO for
14 reverification of previously authorized
15 stock option award grants."

16 Do you see that?

17 **A.** Yes, I do.

18 **Q.** Mr. Pattison, isn't that what you had been telling the
19 auditors for the last -- for the four years preceding the end
20 of 2004; that those grant-approval lists were simply
21 reverifications by the CEO of previously authorized grants?

22 **A.** No, I never told them that.

23 **Q.** You didn't tell them that?

24 **A.** No.

25 **Q.** You didn't -- you didn't lead them to believe that over

1 the course of their audits --

2 **A.** No, I did not lead them to believe that.

3 **Q.** Would you agree, at the very least, that this Equity Cycle
4 Narrative doesn't discuss at all the practice of looking back
5 to select the lowest stock option price for the course of the
6 quarter?

7 **A.** I would agree with that, but it -- it doesn't talk about
8 who gets options, and, you know, how many options. It
9 doesn't -- you know, there's things -- this is, to describe the
10 processes, the controls, the paperwork, how it went from A to B
11 to C to D. It didn't talk about -- at least, mine didn't.

12 I note in this one, you know, it doesn't talk about the
13 delegation; but the delegation is in here. So, you know, it
14 talks about how they're granted from that perspective, at
15 least, mechanically.

16 **Q** Okay. But you would agree that it doesn't discuss the
17 practice of looking back and picking the low stock price of the
18 quarter.

19 **A** Among other things, that's correct. Which, if it were
20 important, you know, the auditors would have asked for it to be
21 in here.

22 And if this -- this went through probably, you know, eight
23 or ten revisions with us, Jefferson Wells, PwC, us, Jefferson
24 Wells, PwC. Got to the point where PwC and Jefferson Wells
25 were working amongst themselves, even, without us being in it.

1 There was just too much work for everybody to be involved
2 in every one of the 25 cycles.

3 **Q** So, you -- if it were important to the auditors, they
4 would have asked for it to be in there. Is that -- is that
5 your testimony?

6 **A** Well, I look at this as, you know, this -- this is
7 intended to be best practices and internal controls to, you
8 know, make sure everything rolls up. So, they had checklists
9 of what they wanted to see in these.

10 And, Jefferson Wells, as the SOX consultants, probably had
11 what would be considered best practices. I'm assuming, after
12 everyone sat there for a year, whatever wanted to be in here,
13 was in here.

14 But again, I wasn't involved in the final discussion. So,
15 I don't know how they negotiated this language. I think there
16 was a lot of back-and-forth.

17 **Q** The practice of looking back to select the lowest price of
18 the quarter, that was done every quarter after Stephen Wong was
19 delegated the authority through the end of the third quarter,
20 2004.

21 Is that fair to say?

22 **A** I -- I -- I think that would be a broad statement. I
23 don't know -- I can't say that that happened every quarter. I
24 know that was the general practice. He could have picked
25 higher, or he could have picked lower.

1 Q It was part of your regular quarterly practice at the end
2 of each quarter to look back?

3 A Not mine. It was Stephen Wong.

4 Q Sure. I understand that he ultimately made the decision,
5 but you helped him identify what the lowest price of the
6 quarter was. Isn't that fair to say?

7 A I don't think Stephen really needed much help from
8 anything, from me.

9 Q So he could have done this all by himself?

10 A He absolutely could have done this by himself.

11 Q But, in fact, you were involved in the grant process
12 quarter after quarter after quarter, weren't you?

13 A Yes, I was.

14 Q Recording equity was important. And that's why the
15 controller did it. Is that right?

16 A I think that that referred more to the SEC filings with
17 respect to the Section 16 officers. But I'm not discounting
18 that it's not important. It's as important as all the rest of
19 the stuff.

20 Q And it was a routine part of the practice for either you
21 or Mr. Wong to look back over the course of the quarter. Isn't
22 that fair to say?

23 A I would say it was routine. I wouldn't say it was me
24 looking back. Stephen Wong had the authorization to grant
25 options pursuant to the delegation, whenever he wanted to.

1 Now, that's a lot of flexibility. That doesn't really
2 make me comfortable. It -- it made it -- it didn't make me
3 comfortable from the perspective of I couldn't, you know, have
4 him issuing grants all the time and he realized that, too.

5 So, you know, we came to a quarterly process.

6 **Q** It didn't make you comfortable at the time? Is that what
7 you're saying?

8 **A** The fact that if people passed him in the hall, and he
9 said, "What about Jason Hahn?"

10 And he said, "Oh, okay."

11 I mean, imagine -- imagine what that would -- the
12 moment-of-time scenario we have been talking about. Right?
13 How would you ever keep track of that?

14 **Q** Did you tell the auditors at the time that you were
15 uncomfortable with that practice?

16 **A** I think I described to you what I was uncomfortable with.
17 I was uncomfortable with the concept of Stephen passing out
18 options in the hallway. That's why we had the quarterly
19 system.

20 **Q** And I asked, did you tell the auditors that you were
21 uncomfortable with that practice?

22 **A** The auditors got every board and committee minute --
23 meeting minutes. And they saw the delegation, and never
24 commented on the delegation.

25 They knew exactly what the delegation was, and what

1 Stephen's rights under the delegation were.

2 **Q** I'm sorry, I didn't hear an answer, though.

3 Did you tell the auditors that you were uncomfortable with
4 that practice?

5 **MR. RICHARD:** Objection; argumentative --

6 **THE WITNESS:** No, the practice didn't --

7 **THE COURT:** Overruled. Overruled.

8 **THE WITNESS:** The practice didn't --

9 **THE COURT:** Hold on, Mr. Pattison.

10 **THE WITNESS:** Yes.

11 **THE COURT:** You need to answer the question yes or
12 no. Then you can explain.

13 **THE WITNESS:** No. The practice didn't happen,
14 because we had a quarterly practice.

15 **BY MR. TASHJIAN:**

16 **Q** Could I ask you to look at Exhibit 131 in your binder.

17 **A** 131?

18 **Q** Yes.

19 (Request complied with by the Defendant)

20 **A** Okay.

21 (Document displayed)

22 **MR. TASHJIAN:** Exhibit 131 is already in evidence,
23 and we are publishing it on the screen.

24 **BY MR. TASHJIAN:**

25 **Q** The e-mail you sent to Saulius Bakas on August 6, 2004,

1 the e-mail contains a number of different narratives, or
2 attaches a number of different narratives.

3 Is that fair to say?

4 **A** Yes.

5 **Q** There were narratives for reporting and disclosure, is
6 that right?

7 **A** Yes.

8 **Q** For financial reporting and disclosure, is that right?

9 **A** Yes.

10 **Q** There's another one for the close narrative, is that
11 right?

12 **A** Yes.

13 **Q** And then finally there's one for the equity narrative. Do
14 you see that?

15 **A** Yes, I do.

16 **Q** In fact, that's the only one that made it into this
17 exhibit. If we could take a look at it, on the next page.

18 (Request complied with by the Defendant)

19 (Document displayed)

20 **MR. TASHJIAN:** If we could flip to the next page,
21 it's the stock option overview -- or stock option grants.

22 Maybe it's next page.

23 (Document displayed)

24 **BY MR. TASHJIAN:**

25 **Q** The sentence about three lines up, the short paragraph

1 that reads (As read):

2 "Controller forwards this list to CEO for
3 approval of proposed grants."

4 Do you see that?

5 **A** Yes.

6 **Q** (As read):

7 "The CEO signs at the bottom of the list to
8 indicate approval."

9 Do you see that?

10 **A** Yes. And "the board" highlight means it's a control.

11 **Q** Meaning the portion that reads:

12 "The CEO signs at the bottom of the list to
13 indicate approval..."

14 That was a control?

15 **A** Yes.

16 **Q** An internal control.

17 **A** Yes.

18 **Q** To make sure that the options were granted properly. Is
19 that right?

20 **A** No, to make sure that there was proper authorization.

21 **Q** You would agree that there's nothing in those two
22 sentences that discusses the practice of looking back to select
23 the lowest price of the quarter, wouldn't you?

24 **A** That's correct.

25 **Q** Now, this version (Indicating), that you sent in August,

1 uses the word "proposed." Do you see that?

2 **A** Yes.

3 **Q** Do you agree that in the version that's dated 12-31-04,
4 that that word "proposed" is not in the description of the
5 granting process?

6 **A** I don't remember that. I know it said "reverification."
7 I don't remember the "proposed." I was focused on something
8 else.

9 **Q** That leads me to my next question. You would agree that
10 the words "reverification of previously authored grants" don't
11 appear in this version. Is that fair to say?

12 **A** That's right.

13 **Q** Could I ask you to turn to Exhibit 312. 312 was an
14 exhibit that your attorney asked you about yesterday, and I
15 think it's in evidence.

16 (Request complied with by the Defendant)

17 (Document displayed)

18 **MR. TASHJIAN:** If we could flash up to the top.

19 (Document displayed)

20 **BY MR. TASHJIAN:**

21 **Q** Richard Janney, now, he was the consultant from Jefferson
22 Wells. Is that right?

23 **A** That's correct.

24 **Q** He was not an employee of Embarcadero?

25 **A** No. He and about four or five other Jefferson Wells

1 people were working, you know, on the SOX project, the 404.

2 **Q** And he came in in mid-2004, is that fair to say?

3 **A** Probably, you know, a little before. Around that time.

4 **Q** So, is it fair to say that Mr. Janney and his team at
5 Jefferson Wells had to learn how the process worked at
6 Embarcadero?

7 **A** That's correct.

8 **Q** I mean, he was helping with you the narratives, is that --
9 is that right?

10 **A** Well, no, I -- I think they all started off -- you know,
11 we saw that July 1, 2002 internal control memorandum. So, that
12 was kind of a precursor to the Sarbanes-Oxley. And then you
13 saw my version.

14 So, he would have taken my version, and I guess the -- you
15 know, the best way I could put it would be customize it for
16 best practices.

17 **Q** Okay.

18 **A** To -- to, you know, Sarbanes-Oxley-ize it.

19 **Q** Well, he worked with you, is it fair to say, to learn how
20 -- what the process was at Embarcadero for granting stock
21 options?

22 **A** He worked with -- yes.

23 **Q** And he had to help you document the process in the
24 narratives. Is that right?

25 **A** Yeah, me or others.

1 **Q** Now, you never told Mr. Janney that you looked back and
2 selected the lowest price of the quarter for the employee stock
3 option grants, did you?

4 **A** You know, this gets back to the -- you know, the
5 discussions you asked me with the auditors. I -- I can't
6 remember specific questions. So, I mean, if you would want to
7 rephrase it with a "more likely than not" or something like
8 that.

9 I just can't imagine over, you know, what the auditors --
10 over the course of five and a half years, based on everything
11 we've looked at, that there was a question in their minds. But
12 I can't speculate.

13 As far as my questions with Richard -- my -- my
14 conversations with Richard Janney, I can't recall any specific
15 conversation. You know, I -- I'm not quite sure that -- he
16 would have taken my narrative and known what the process was.
17 You just saw it.

18 So, how we went from there, I kind of fell out of the
19 process, based on other, you know, issues. So, I wish -- I
20 wish I knew.

21 **Q** You received this e-mail, dated October 22nd. That's a
22 Friday, according to the e-mail, is that right?

23 **A** Right.

24 **Q** He sent it to you and to Mr. Sabhlok, is that right?

25 **A** To Mr. Sabhlok, and cc me, yes.

1 Q Well, let's look at the next page, which is the first page
2 of the attachment to the e-mail.

3 (Document displayed)

4 Q You will see bubbles over on the right-hand column that
5 says "Deleted." Do you see that?

6 A Yes, I do.

7 Q Is it fair to say that the attachment to the e-mail in
8 Exhibit 312 reflects edits to the prior draft of the equity
9 cycle narrative?

10 A I'm sorry; can you repeat that?

11 Q Is it fair to say that by looking at the bubbles on the
12 right-hand column, and other edits in the document, that the
13 attachment reflects edits to the equity cycle narrative?

14 A That's correct. I know at this time, we had recently got
15 comments from PwC. And so, we were incorporating their
16 comments into the document. Or, Richard Janney was.

17 Q If you look at the third page of the attachment, you see a
18 number of --

19 (Document displayed)

20 MR. TASHJIAN: If we can blow up the right-hand
21 column, so that you can see what's been deleted in the bubbles.

22 (Document displayed)

23 BY MR. TASHJIAN:

24 Q You will see in the fourth bubble down, the word
25 "proposed" was deleted. Do you see that?

1 **A** Yes.

2 **Q** And then two bubbles down from that, the word -- the
3 phrase "and proper authorization of the proposed stock
4 award/option grants."

5 Do you see those words were deleted?

6 **A** Yes, I do.

7 **Q** And then, if you look in the text of the document, over on
8 the left-hand side, so, the -- the paragraph that begins "The
9 Controller forwards the Option Activity worksheet..." that
10 paragraph?

11 **A** You've lost me, sorry, because I'm not on the screen.

12 **MR. TASHJIAN:** Mr. King, if you could blow up the
13 entire paragraph, that would be helpful.

14 (Document displayed)

15 **THE WITNESS:** Got it.

16 **BY MR. TASHJIAN:**

17 **Q** (As read):

18 "The Controller forwards the Option Activity
19 worksheet to the CEO for..."

20 The word "verification" has been edited. Do you see that?

21 **A** I do.

22 **Q** The word, the letters "re," or r-e, have been added in
23 front of "verification." Do you see that?

24 **A** Yes.

25 **Q** Would you agree that that's one of the edits that was made

1 in Mr. Janney's e-mail, dated October 22, 2004?

2 **A** It certainly appears to be, yes. It would be helpful to
3 look at this in the context of the PwC comments. I don't know
4 whether they commented on that specific piece.

5 **Q** Now, if you --

6 **MR. TASHJIAN:** Mr. King, if you could go to the front
7 page of the e-mail. The first page of the Exhibit.

8 (Document displayed)

9 **BY MR. TASHJIAN:**

10 **Q** You will see, the -- that October 22nd was a Friday. Is
11 that right?

12 **A** Yes.

13 **Q** If we could take a look at Exhibit 424, which may or may
14 not be in your binder.

15 **A** It is.

16 **Q** It is?

17 **THE COURT:** Not mine.

18 **THE CLERK:** It's admitted.

19 **MR. TASHJIAN:** I've got a copy. Your Honor, may I
20 hand it up?

21 **THE COURT:** I have it in my big binder here.

22 **MR. TASHJIAN:** Okay, we have -- just as easy to look
23 at.

24 **THE COURT:** Okay.

25 (Document handed up to the Court)

1 **MR. TASHJIAN:** Mr. King, if you could keep that
2 e-mail on the -- 312, please.

3 (Document displayed)

4 **BY MR. TASHJIAN:**

5 **Q** All right. Mr. Pattison, if you look at Exhibit 424 --

6 **MR. TASHJIAN:** I believe 424 was moved into evidence,
7 perhaps yesterday.

8 **THE CLERK:** (Nods head)

9 **BY MR. TASHJIAN:**

10 **Q** It's the 8-K that was filed on October 27, 2004.

11 Do you see that?

12 **A** Yes, I do.

13 **Q** And there was a press release attached as part of the Form
14 8-K. Do you see that?

15 **A** Yes.

16 **Q** Which is the press release that's titled "Embarcadero
17 Technologies Postpones Earnings Announcement," is that right?

18 **A** Correct.

19 **Q** And this was the announcement by which Embarcadero told
20 the public and its shareholders that it wasn't going to be able
21 to file the third quarter 10-Q on time.

22 Is that right?

23 **A** That's right.

24 **Q** And it makes a reference to the reference recognition
25 investigation. Do you see that, in the text of the press

1 release?

2 **A** Yes. (As read):

3 "The audit committee this week commenced an
4 investigation on the revenue recognition
5 practices of its UK subsidiary."

6 **Q** Right. So it's the sentence that says (As read):

7 "The company also announced that its audit
8 committee this week commenced an
9 investigation of the revenue recognition
10 practices in the UK subsidiary."

11 Do you see that?

12 **A** Yes, I do.

13 **Q** October 27th I believe is a Wednesday. Is that fair to
14 say?

15 **A** I don't -- I don't know.

16 **Q** Is it fair to say --

17 **A** Tuesday?

18 **Q** A Wednesday, I believe.

19 **A** Okay.

20 **MR. TASHJIAN:** We can call up Exhibit 653, that's the
21 stock price list.

22 **MR. RICHARD:** I think we can agree, Wednesday.

23 **MR. TASHJIAN:** Do you want to take judicial notice of
24 it?

25 **MR. RICHARD:** Today's Tuesday still, right?

1 **THE WITNESS:** Yeah, it's Wednesday.

2 **MR. RICHARD:** Yeah. I'm just going from the Friday,
3 October 22nd, and I did a little note, and it looks like it's
4 Wednesday the 27th.

5 **THE COURT:** Maybe you all can stipulate to that.
6 How's that?

7 **MR. TASHJIAN:** We can agree on something, Your Honor.

8 **THE COURT:** Good, good. Note that for the Record.

9 **MR. RICHARD:** So stipulated.

10 **THE COURT:** Okay. Thank you.

11 **MR. TASHJIAN:** Okay.

12 **BY MR. TASHJIAN:**

13 **Q** So, would you agree, then -- well, in the very least, that
14 Mr. Janney sent you the revision to the equity cycle narrative
15 the week before the company made its announcement.

16 Is that fair to say?

17 **A** Yes.

18 **Q** Could I ask you to turn to Exhibit 22, Mr. Pattison.

19 **MR. TASHJIAN:** I believe Exhibit 22 is already in
20 evidence.

21 **THE CLERK:** (Nods head)

22 **MR. TASHJIAN:** If we could flash it up.

23 (Document displayed)

24 **BY MR. TASHJIAN:**

25 **Q** This is the e-mail that's dated September 16, 2004, about

1 the third quarter prospective grants.

2 Do you see that?

3 **A** Yes, I do.

4 **Q** September 16th is a couple of weeks before the end of the
5 third quarter 2004.

6 Is that right?

7 **A** Yes.

8 **Q** And if we look at the next page --

9 (Document displayed)

10 **Q** You will see the grant list. There's -- would you agree
11 that there are no dates or prices that are reflected in the
12 list that you sent Mr. Wong on September 16th?

13 **A** Right. It's a proposed prospective grant list.

14 **Q** That's right. And your note at the top of the spreadsheet
15 says (As read):

16 "TO BE ISSUED AT LOW IN THE QUARTER BUT NOT
17 BEFORE START DATE."

18 Do you see that?

19 **A** Yes.

20 **Q** That meant that the people that are listed on the
21 left-hand side in the column are the new-hire grants.

22 Is that a fair assumption?

23 **A** That was the practice, so I'm assuming so, yes.

24 **Q** And then the next batch of grants, you wrote, made a note
25 that says (As read):

1 "REQUIRES A COMP COMMITTEE MEETING TO GET
2 ISSUED."

3 Do you see that?

4 **A** Yes, I do.

5 **Q** Those were grants that were approved by the compensation
6 committee meeting of the board of directors. Is that right?

7 **A** Well, I don't know whether it had -- had taken place or
8 not taken place. But, it would have required, what is I'm
9 saying.

10 I'm not quite sure under what, you know, premise it would
11 have been.

12 **Q** The grants underneath the heading "TO BE ISSUED AT LOW IN
13 THE QUARTER," those are the performance grants for the third
14 quarter. Is that fair to say?

15 **A** Yes.

16 **Q** So, taking a look at the fact that -- by the fact that
17 there are no dates or prices indicated in your spreadsheet, is
18 it a fair interpretation of this document that Stephen Wong had
19 not yet approved or decided on the grants that are reflected on
20 the list?

21 **A** Yes.

22 **Q** If I could ask you to turn to Exhibit 606.

23 **MR. TASHJIAN:** Your Honor, Exhibit 606 is an e-mail
24 that the Defendant sent to E*TRADE on October 6th, 2004.

25

1 **BY MR. TASHJIAN:**

2 **Q** Mr. Pattison, would you agree that Exhibit 606 reflects
3 the third quarter of 2004 grants that you sent?

4 **A** Yes.

5 **MR. TASHJIAN:** And I would ask that Exhibit 606 be
6 moved into evidence.

7 **THE CLERK:** It already is.

8 **MR. TASHJIAN:** It is?

9 **THE CLERK:** 606, yes.

10 **MR. TASHJIAN:** What's great. Thanks.

11 **THE COURT:** That saves a step.

12 (Document displayed)

13 **BY MR. TASHJIAN:**

14 **Q** So, Melisa Enke, she was your contact at E*TRADE at the
15 time, in the third and fourth quarter 2004, is that fair to
16 say?

17 **A** Yes.

18 **Q** And you're sending her the third quarter 2004 grant list.

19 **A** Yes, I am.

20 **Q** October 6th was six days into the fourth quarter of 2004,
21 is that right?

22 **A** Yes.

23 **Q** And if we look at the list, itself, on the next page,
24 you'll see the columns that were for "Account ID," those were
25 the IDs for the different grantees, the employees who were to

1 receive stock options, is that right?

2 **A** Correct.

3 **Q** And the "Option Date," there's a column for "Option Date,"
4 do you see that?

5 **A** Yes, I do.

6 **Q** The option date is August 13th, 2004. Do you see that?

7 **A** Yes, I do.

8 **Q** The grant date -- the grant date market value, \$5.95, do
9 you see that?

10 **A** Yes.

11 **Q** That was the exercise price for those options? That's
12 what you're telling E*TRADE, is that right?

13 **A** Right. And the fair market value on that option date.

14 **Q** I'm sorry, maybe -- the exercise price is the \$5.95 in the
15 next column?

16 **A** Yeah, I'm not sure what the distinction is between those
17 two columns.

18 **Q** August 13th, 2004, is it fair to say that \$5.95 was the
19 lowest stock price in the third quarter, 2004?

20 (Defendant examines document)

21 **A** It's likely.

22 **Q** If we could take a look at Exhibit 44, which your attorney
23 showed you yesterday.

24 **MR. TASHJIAN:** I think that one -- I know that one's
25 in evidence.

1 **THE CLERK:** Yes.

2 (Document displayed)

3 **BY MR. TASHJIAN:**

4 **Q** At the top of Exhibit 44, you wrote to Mr. Sabhlok (As
5 read):

6 "I will get a summary for you by end of day.

7 I have discussed the VP issue with Stephen

8 Ferruolo."

9 Now, Stephen Ferruolo was the outside attorney for the
10 company?

11 **A** Yes.

12 **Q** You would occasionally ask him questions if you had
13 questions; is that fair to say?

14 **A** Yes.

15 **Q** And in fact, in this e-mail, you seem to suggest that you
16 -- that you talked to him about a particular issue.

17 Is that right?

18 **A** Yes.

19 **Q** And the summary -- the summary in your e-mail that you
20 referenced in the first sentence, is it fair to say that that's
21 a summary of the grants for the third quarter, 2004?

22 (Defendant examines document)

23 **A** Sorry, if you could just help me with that.

24 **Q** Sure.

25 **A** Are you saying I included the summary or something? Or --

1 Q I'm -- no, I'm -- I'm just trying to ask questions here.
2 Somewhat successfully, and somewhat unsuccessfully.

3 Mr. Sabhlok wrote, in his e-mail --

4 A Okay.

5 Q "Do you have the specifics on the others?"

6 And you said, "I will get the summary for you by the end
7 of the day."

8 Is it fair to say that your summary -- that you're
9 referring to the summary of the stock options for the third
10 quarter, 2004?

11 A I -- he states (As read): "Okay, do you have the specifics
12 on the others?"

13 I don't know if that means the others, meaning the group
14 that this whole e-mail discusses, which is, you know,
15 Mr. Lamvik and his group. So, I'm not sure. If I could read
16 through this to -- I'm not sure what he was referring to.

17 Q Okay. You are saying you don't have a recollection now as
18 to what you were referring to when he said "the summary."

19 A No. And, nor -- nor do I recall the VP issue with Stephen
20 Ferruolo. It must have had to do either with Stephen's
21 delegation, or -- or Mr. Lamvik.

22 Q Your attorney asked you yesterday about some -- an e-mail
23 that appears further down in the chain on the second page of
24 the exhibit.

25 Mr. Sabhlok forwarded you an exchange between Mr. Wong and

1 Mr. Lamvik. Do you see that?

2 **A** Yes.

3 **Q** Mr. Lamvik was the head of sales at the time?

4 **A** I believe he was, yes.

5 **Q** And, in --

6 **MR. TASHJIAN:** Mr. King, if you could blow that up
7 and -- blow up Mr. Wong's message. The entire thing.

8 (Document displayed)

9 **BY MR. TASHJIAN:**

10 **Q** He wrote to Mr. Lamvik (As read):

11 "Bryan and Duncan made out like bandits..."

12 Now, that's Bryan Fujimoto, is that right?

13 **A** Yes.

14 **Q** Duncan was Duncan Hoffman?

15 **A** Yes.

16 **Q** Their names appeared on the grant list that we saw that
17 was marked as Exhibit 22?

18 **A** Well, in the e-mail prior to this one, as well.

19 **Q** "...because they are not VPs, I have discretion to make
20 their grants."

21 That meant -- Mr. Wong was saying -- is it a fair
22 interpretation to say he had been delegated the authority to
23 grant stock options to non-VPs? Or, to non-senior executives
24 of the company.

25 **A** Right. That, that, I agree with. I'm not really quite

1 sure. I mean, he's talking about the delegation changing here.
2 So, I don't remember the final change in the delegation,
3 actually, so --

4 **Q** You would agree, though, that there were certain grants --
5 certain grants that Mr. Wong had the authority to approve, and
6 certain grants that the board had to approve.

7 Is that right?

8 **A** Right.

9 **Q** He wrote (As read): I have discretion to make their
10 grants."

11 And, he's referring to Mr. Fujimoto and Mr. Hoffman's
12 grants. Is that a fair interpretation?

13 **A** It appears to be, yes.

14 **Q** He wrote (As read):

15 "By some strange coincidence, this happened
16 at the low price for the quarter, less than
17 \$6."

18 Do you see that?

19 **A** Yes.

20 **Q** He contrasted that in the next sentence by saying (As
21 read):

22 "Unfortunately you and Jaywant have to go
23 through a different process..."

24 Do you see that?

25 **A** Yes, I do.

1 Q And that different process, he described it as one "that
2 gets recorded and validated." Do you see that?

3 A Yes, I do.

4 Q And he's referring to the process at the board level. Is
5 that right?

6 A He must be, yes. I mean, not his delegation, so it would
7 be the board of the compensation committee.

8 Q And the one way that it got recorded and validated, there
9 are minutes of those board meetings, is that right?

10 A Yes.

11 Q Mr. Ferruolo, from outside the company, would take those
12 minutes?

13 A Yes.

14 Q Those minutes would be kept in board books at the company,
15 is that right?

16 A Yes, they would.

17 Q And they would be opened to the auditors, is that right?

18 A That's right, yep.

19 MR. TASHJIAN: I think this is probably a good time
20 for a break, Your Honor.

21 THE COURT: All. Right we will take our 15-minute
22 break. Come back at 10:15 and we will resume. Thank you.

23 THE CLERK: All rise for the jury.

24 (Jury excused)

25 (The following proceedings were held in open court

1 outside of the presence of the jury:)

2 **THE CLERK:** Please be seated.

3 **THE COURT:** How much longer do you expect your cross
4 will go?

5 **MR. TASHJIAN:** Twenty-five minutes to half hour.

6 **THE COURT:** All right. Because that -- that's going
7 to be about the maximum, if we are going to be able to get in,
8 as we talked about yesterday, taking Mr. Lehn out of order.

9 Because I have given an hour and a half, and you may
10 have an hour, and that allows -- basically, allows about two
11 and a half hours.

12 Well, I added on an extra half hour today, didn't I?
13 All I'm saying is we only have so much time.

14 **MR. TASHJIAN:** I will do my best to move this along.

15 **MR. RICHARD:** I would waive my right to object on
16 recross to scope, if Counsel wants to --

17 **THE COURT:** That's the other thing you can do, you
18 can also -- with that, I was going to suggest, you know, you
19 can also just stop, and then -- a little bit -- discontinuous.

20 Or, if we're anxiously awaiting the right of scope on
21 recross, you can ask some of the questions you -- if you don't
22 quite get to finish -- in other words, we just say a half an
23 hour either way, then we can be sure that Mr. Lehn will get on.

24 **MR. TASHJIAN:** I guess I would prefer to go forward
25 for the next 25 minutes to half hour. If I can't finish it

1 then, we can reconsider it then.

2 **THE COURT:** Okay.

3 **MR. TASHJIAN:** That's how I would prefer.

4 **THE COURT:** Okay. I'll watch that clock carefully.

5 Now, just to be clear, I'm allocating an hour and a
6 half, as I said yesterday, for you to do Mr. Lehn. You have an
7 hour and 20 minutes left here.

8 And I assume your redirect -- I'm not giving you
9 extra time. I mean, I'm going to give you time to do --
10 that'll come off the hour and 20.

11 **MR. RICHARD:** I understand.

12 **THE COURT:** That's separate from the hour and a half.

13 **MR. RICHARD:** Yeah. I expect, at the end of the day,
14 we'll sort out, and see where we are --

15 **THE COURT:** Yeah.

16 **MR. RICHARD:** -- on that. I will try to finish
17 Professor Lehn in an hour, to save a few minutes for redirect.

18 **THE COURT:** Okay.

19 **MS. LaMARCA:** And just to alert the Court, there are
20 some -- I hope minor -- exhibit issues with Professor Lehn.

21 We learned late last night that there were some
22 documents that were sent to us the prior date as
23 demonstratives, which now the Defendant is calling exhibits.
24 They're not appropriate to be used as exhibits.

25 But, we also had problems with a couple of those

1 because they are not matters contained in Mr. Lehn's report.

2 **THE COURT:** Okay. Then, we'd better talk about that
3 now, because he's going to be on in a half an hour.

4 **THE DEFENDANT:** May I step down, please?

5 **THE COURT:** Yeah, I'm sorry. Yeah, yeah.

6 **THE DEFENDANT:** Thank you.

7 (Defendant excused from the witness stand)

8 **MS. LaMARCA:** So, I think I brought an extra copy of
9 the ones that were sent to me last night. I think it's easiest
10 to use the -- and I'll hand it up to the Court -- the exhibit
11 numbers that the Defendant provided.

12 I just want to make sure these are the right -- yeah.

13 (Document handed up to the Court)

14 **THE COURT:** Does somebody have the copy of the
15 report, the expert report? I don't have that with me.

16 **MS. LaMARCA:** I have, one but it has markings. I may
17 have another.

18 **THE COURT:** Okay, we've got one.

19 **MS. LaMARCA:** All right.

20 **THE COURT:** Okay.

21 **MS. LaMARCA:** So the first -- and, Counsel was good
22 enough to give us an e-mail this morning, or last night, that
23 pointed out places that they believed these tied to.

24 I think if we start at the back, the -- the very
25 final exhibit, 922, is the one that we have most heartburn

1 over, because we don't see anything in Mr. Lehn's report
2 remotely describing testimony that would fit with this exhibit,
3 which is a description of, I guess, negotiations that were
4 occurring between Embarcadero and an acquirer between June,
5 2006 and September, 2006.

6 And, Mr. Lehn says nothing about those negotiations
7 in his report. Or in his deposition. But, I don't think the
8 deposition counts, in any event.

9 **THE COURT:** Okay. What's the response to that?

10 **MR. RICHARD:** Well, one, to say that the deposition
11 doesn't count in any event I don't think is quite accurate.
12 We're here to talk about fair notice.

13 This exhibit, 922, refers to -- I think it's in his
14 -- appendix?

15 (Short off-the-Record discussion)

16 **MS. LaMARCA:** We were told, depo at 174. That was
17 what we were told. And I looked at --

18 **MR. RICHARD:** You know what, Your Honor? I'm going
19 to just withdraw this at this point, because it's so much
20 information, it would cut into my time.

21 If we need to call Professor Lehn as a rebuttal to
22 the points that the Government may or may not make with
23 Mr. Mulcahey, we will revisit at that time. But --

24 **MS. LaMARCA:** Actually, that will shorten everything,
25 because all my -- the remainder of my objections, if we could

1 actually just hash that out.

2 We absolutely do not know whether we will call
3 Mr. Mulcahey, to be completely frank. We want a shorter case.
4 So, we would object in general to the presentation by Mr. Lehn
5 of critiques of Mr. Mulcahey, which won't be in evidence.

6 And so, if -- If counsel would reserve those for, I
7 guess, surrebuttal, or rebuttal-rebuttal of Mr. Mulcahey, then
8 we would be fine. Just, dealing with those exhibits later if
9 we need to.

10 And, I actually wouldn't stand on a protest about his
11 objections to Mr. Mulcahey at a later date. But I would, at
12 this date.

13 **THE COURT:** All right. All right. So that takes
14 care of this one.

15 **MS LaMARCA:** Yes. I think -- it also takes care of
16 slide -- I guess, 920?

17 **THE COURT:** Okay.

18 **MS. LaMARCA:** That's a later-events study that
19 apparently Mister -- Mr. Lehn must have done after we deposed
20 him, because he had only done some preliminary analysis at that
21 point.

22 **MR. RICHARD:** And this is a very straightforward
23 point, Your Honor, that is referred to in his report and his
24 deposition.

25 The concept that, very generally, there's a run-up in

1 stock price before a formal announcement of a merger. This is
2 absolutely no surprise. It's an important part of this
3 economist's observations. And, there's no question he was
4 asked about it in his deposition.

5 So, I think that we're really trying to slice this a
6 little too finely, in terms of what this witness should be
7 permitted to explain to the jury on these important issues of
8 -- of economics. Especially in a case where the Government
9 presented no expert in their own case in chief, we should be
10 entitled to tell --

11 **THE COURT:** Where in the report is there some
12 reference to effective merger announcements and price effects
13 and stuff?

14 Is there something in here, some page you can direct
15 me to?

16 **MR. RICHARD:** It's -- I believe he cites -- I don't
17 think it is in the particulars of his report, Your Honor. He
18 attaches some information that he was then asked about in his
19 deposition.

20 He attaches a lengthy study on employee stock options
21 called -- *The Cost of Employee Stock Options*.

22 But, let me see if I can find it in the deposition,
23 Your Honor. I believe it's --

24 **MS. LaMARCA:** We were only pointed to the deposition,
25 not to any place in the report.

1 **THE COURT:** I think he just said that.

2 **MS. LaMARCA:** Oh, I'm sorry.

3 **THE COURT:** What is run-up?

4 **MR. RICHARD:** Oh, yes, Your Honor. That, if you look
5 at Exhibit 920, the Government has tried to suggest to the jury
6 that if you look at the price of the company's stock a couple
7 days before, that should be the starting point of some
8 post-period analysis.

9 When, in fact, it's critical to look at when the
10 parties first started negotiating, which is in June. And so,
11 it gives us a different price point, to put this in context.

12 So to the extent that the Government can go to the
13 jury and say, "Oh, let's look at the company's stock price a
14 couple of days before the merger was announced," and try to
15 draw some conclusion from that, that's contrary to sound
16 economics.

17 Study after study recognized, and it's a point beyond
18 debate that the market, either through leakage of information,
19 all the people who learn about the merger in the course of
20 those discussions, or the market, itself, analyzing that
21 whatever Thoma Cressey saw as additional value in this company,
22 the market also saw.

23 So, there's a creep-up from when the negotiations
24 began in June to when the merger was announced. The point is
25 that simple. It will take about two minutes of Professor

1 Lehn's testimony to explain that point.

2 I'll look for where that was discussed in his
3 deposition. But, it's an issue that the Government has
4 presented to the jury without expert testimony.

5 So, to suggest that I can't respond because they
6 weren't required to comply with disclosure requirements for
7 experts, but, oh, Mr. Richard did comply, but now he's limited
8 to the exact text of his deposition --

9 **THE COURT:** Well, it would be helpful -- if there was
10 any discussion of this in the deposition, that would be useful
11 to know.

12 **MR. RICHARD:** Okay.

13 **THE COURT:** Hold on for a second.

14 (A pause in the proceedings)

15 **THE COURT:** I have to take a quick recess.

16 **MR. RICHARD:** That'll give me an opportunity. Thank
17 you, Your Honor.

18 **THE COURT:** All right.

19 (Recess taken from 10:10 to 10:17 a.m.)

20 (The following proceedings were held in open court
21 outside of the presence of the jury:)

22 **THE COURT:** All right. Can we -- we need to resume,
23 because we need to bring the jury back in. I don't want to
24 lose much more time.

25 **MS. LaMARCA:** You meant the discussion?

1 **THE COURT:** Yes.

2 **MS. LaMARCA:** Okay.

3 **THE COURT:** I --

4 **MR. MACAULAY:** Sure, Your Honor. All of Mr. Lehn's
5 discussion in this 2000 time frame -- 2006 time period, in both
6 his report and his deposition, focuses on the disclosures
7 beginning in November 10, 2006.

8 I can't find a specific reference to the pre-merger
9 discussions. So, I don't know if we have a way to edit our --
10 I'll limit my questions. We are going to remove Exhibit Slide
11 920, because I can't find a specific reference in --

12 **THE COURT:** Yeah. I have to say, after now rereading
13 his report, I mean, the gist of his testimony is about -- you
14 know, you've got all the information, it's not material, that's
15 not how -- it's the how-investors-decide kind of stuff that
16 you're -- and I don't see -- that's on a different track.

17 So, I'm inclined -- I would have been inclined anyway
18 to say it's --

19 **MR. RICHARD:** He does address what confounding
20 information is, in both his report and in his deposition.

21 **THE COURT:** Well, and he can talk about that.

22 **MR. RICHARD:** Okay.

23 **THE COURT:** But to get into this level is kind of a
24 different orbit, it seems to me.

25 **MR. RICHARD:** Okay.

1 **THE COURT:** What about the rest of these things?
2 What's wrong with these other slides?

3 **MS. LaMARCA:** I think that our objections -- if I
4 could understand from Counsel, actually, I -- I'm guessing,
5 based on what we were discussing a moment ago, that Exhibit 918
6 is one of the -- is that -- is that not one of the -- I'm
7 sorry.

8 Is that one of the ones that is staying in? Or is
9 that one of the rebuttal ones? I just want to know, because
10 I'm not sure I object to it.

11 **MR. RICHARD:** Yes.

12 **MS. LaMARCA:** It is staying in?

13 **MR. RICHARD:** It's illustrative of the core of his
14 testimony about what an intrinsic expense is, over time, and
15 how that compares to a compensation expense.

16 **MS. LaMARCA:** Okay. Your Honor, with that, we
17 wouldn't object to it as a demonstrative, illustrative. We
18 would object to any of these as evidence.

19 **THE COURT:** Okay.

20 **MS. LaMARCA:** But we don't object --

21 **THE COURT:** So all these are okay as demonstratives.
22 Your objection is to actually admit these as evidence? Is that
23 what you're saying?

24 915, -17, -16 or whatever it is -- yeah, -16, -18 --
25 918, 919 and 921?

1 **MS. LaMARCA:** And to be clear, our objection would
2 be, in part, hearsay.

3 **THE COURT:** Well, it's an expert.

4 **MS. LaMARCA:** He is, but an expert can talk about
5 what he relies on, but it doesn't make it admissible evidence
6 that he -- his opinion, in words.

7 We never admit expert reports, except for
8 inconsistent statements.

9 **MR. RICHARD:** So, two things. We're not offering
10 these into evidence at this point. We're not moving his expert
11 report into evidence. I have done research on when
12 illustrative exhibits are admissible.

13 But, before we move these into evidence, I would
14 brief that distinction when illustrative evidence comes into
15 evidence. But, for purposes of getting this witness on and off
16 the stand, I would like to show him these five slides, and --

17 **THE COURT:** All right. And you won't be moving
18 today, until we have a fuller discussion, if we so choose, to
19 move these into evidence --

20 **MR. RICHARD:** Yes, Your Honor.

21 **THE COURT:** -- at a later point.

22 **MR. RICHARD:** Yes, Your Honor.

23 **MS. LaMARCA:** Thank you, Your Honor.

24 **THE COURT:** Let's bring the jury back.

25 **MR. RICHARD:** Can I have two minutes, please?

1 **THE COURT:** Okay, all right.

2 **MR. RICHARD:** Thank you.

3 **THE COURT:** Can I hang onto this report for now, in
4 case something comes up? And I'll give you it back to you
5 afterwards?

6 **MR. MARVIN:** Yeah. It's an extra copy.

7 (Recess taken from 10:22 to 10:25 a.m.)

8 (The following proceedings were held in open court
9 outside of the presence of the jury:)

10 **THE COURT:** Okay.

11 (The following proceedings were held in open court in
12 the presence of the jury:)

13 **THE CLERK:** Please be seated.

14 **THE COURT:** Okay. Welcome back, ladies and
15 gentlemen.

16 Sorry again for the delay, but we had some additional
17 matters to take care of. But, we're working very hard, I can
18 assure you of that, to move this along.

19 So, let's pick up where we left off.

20 **MR. TASHJIAN:** Thank you, Your Honor.

21 **CROSS EXAMINATION, RESUMED**

22 **BY MR. TASHJIAN:**

23 **Q** Mr. Pattison, can I ask you to look at Exhibit 24 in your
24 binder. This is the e-mail that's dated -- the e-mail exchange
25 that's dated October 21, 2004.

1 **MR. TASHJIAN:** If we can show it on the screen, too.

2 (Document displayed)

3 **THE WITNESS:** Got it.

4 **BY MR. TASHJIAN:**

5 **Q** Now, there's been a fair amount of discussion about
6 Mr. Ferruolo's response to Mr. Sabhlok's question. And he
7 wrote: "No. Absolutely not."

8 **MR. TASHJIAN:** If we can scroll up, Mr. King?

9 (Document displayed)

10 **BY MR. TASHJIAN:**

11 **Q** You would agree that Mr. Sabhlok forwarded Mr. Ferruolo's
12 response to his question to you on the 21st of October. Do you
13 see that?

14 **A** Yes. I agree.

15 **Q** You don't dispute that you received this e-mail on
16 October 21st?

17 **A** I don't dispute it.

18 **Q** Would you agree that either in e-mail or on telephone --
19 by telephone, on the 21st of October, 2004, you did not tell
20 Mr. Ferruolo that in fact, the company had been selecting the
21 low price of the quarter for its stock option grants for the
22 prior four years.

23 **A** I would agree with that, because I don't think I talked to
24 Mr. Ferruolo.

25 **Q** And would you agree that we haven't seen an e-mail where

1 you told him that in an e-mail, either? Is that fair to say?

2 **A** That's right. I mean, in context, I don't know why I
3 would have inserted myself into this process. I wasn't on the
4 original e-mail.

5 **Q** So, would you also agree that you didn't tell Mr. Ferruolo
6 on October 21st, that the third quarter 2004 grants had been
7 priced at the low of the quarter?

8 **A** Yeah. This doesn't have anything to do with the Q3
9 grants, or, you know, grants of options, as far as I -- I knew.

10 **Q** Could I ask you to turn to Exhibit 311 in your binder.

11 (Request complied with by the Defendant)

12 **MR. TASHJIAN:** Your Honor, the parties have the same
13 stipulation regarding this e-mail, and the attachment. This
14 was an e-mail that Mr. Pattison received on October 21st, 2004.

15 **BY MR. TASHJIAN:**

16 **Q** Mr. Pattison, would you, do you recognize the name
17 "Richard Janney"?

18 **A** Yes, I do.

19 **Q** And, would you agree that this e-mail has to do --
20 something with the equity cycle narrative?

21 **A** Yes.

22 **MR. TASHJIAN:** Your Honor, I would ask that 311 be
23 moved into evidence.

24 **THE COURT:** Any objection?

25 **MR. RICHARD:** No, Your Honor; thank you.

1 **THE COURT:** Admitted.

2 (Trial Exhibit 311 received in evidence)

3 (Document displayed)

4 **MR. TASHJIAN:** Could we blow up the date?

5 (Document displayed)

6 **BY MR. TASHJIAN:**

7 **Q** You will see that Mr. Janney, he was the consultant at
8 Jefferson Wells who was working on the equity cycle narrative
9 with you?

10 **A** Yes.

11 **Q** He sent you this e-mail on October 21st. Do you see that?

12 **A** He sent it to Raj and I, yes.

13 **Q** Okay. To both of you. I don't mean to focus only on you,
14 but you're here.

15 **A** Okay.

16 **Q** To Mr. Sabhlok, the CFO. And he attaches an equity
17 narrative audit zip file, with a date, 10-21-04.

18 Do you see that?

19 **A** Yes.

20 **Q** And if you look at the attachment, you'll see another
21 draft of the equity cycle narrative that Mr. Janney sent you on
22 the 21st.

23 Do you see that?

24 **A** Yes, I do.

25 **Q** And if you look at the Page 2 of 11 on the draft --

1 **MR. TASHJIAN:** The second page, Mr. King.

2 (Document displayed)

3 **BY MR. TASHJIAN:**

4 **Q** Towards the bottom, you will see the language that uses
5 the words "Proposed."

6 So, for example, on the second paragraph up from the
7 bottom, it says (As read):

8 "On a quarterly basis, the Controller then
9 prepares the Option Activity worksheet
10 containing approved and proposed grants in an
11 Excel workbook."

12 Do you see that?

13 **A** Yes, I do.

14 **Q** And then in the final paragraph on that page, the first
15 sentence reads (As read):

16 "The Controller forwards the Option Activity
17 worksheet to the CEO for verification of
18 previously authorized stock option/award
19 grants and proper authorization of the
20 proposed award/option grants."

21 Do you see that?

22 **A** Yes.

23 **Q** And you received this e-mail -- you and Mr. Sabhlok
24 received this e-mail on the 21st of October, 2004.

25 Is that correct?

1 **A** Yes I did. It looks like a different format, at least
2 part of it, so I'm not sure if there were other changes or what
3 he was -- you know, working on here.

4 **Q** Are you referring to the fact that there's no border
5 around the text on the second and third pages?

6 **A** Right. That's the first time I've seen that.

7 I know at this point -- you know, it's 8:00 on the 21st.
8 I'm knee-deep in, you know, the rev rec investigation. So,
9 whether I received this or reviewed it at -- you know,
10 subsequent to this date, I don't know specifically.

11 **Q** Fair enough. Could I ask you to look at Exhibit 154.

12 **A** Yes.

13 (Request complied with by the Defendant)

14 **MR. TASHJIAN:** I believe Exhibit 154 is already in
15 evidence.

16 **BY MR. TASHJIAN:**

17 **Q** This was an e-mail that -- an e-mail exchange between you
18 and Nichole Cerles McKenzie on October 25th, 2004.

19 Do you see that?

20 **A** Yes.

21 **MR. TASHJIAN:** If we could show it.

22 **BY MR. TASHJIAN:**

23 **Q** Ms. McKenzie wrote on the second e-mail --

24 **MR. TASHJIAN:** So if we could scroll up, Mr. King?

25 (Document displayed)

1 **BY MR. TASHJIAN:**

2 **Q** I'm sorry. Mr. Pattison, you wrote to Mister --

3 Ms. Cerles, on the 25th of October (As read):

4 "Here are the new grant templates as well as
5 the options and restricted stock awards to be
6 prepared in Q3."

7 Do you see that?

8 **A** Yes, I do.

9 **Q** Is it fair to say that you were referring to the third
10 quarter 2004 stock option grants?

11 **A** And restricted stock awards.

12 **Q** Sure. Restricted stock is another form of equity that
13 company used to compensate its employees. Is that right?

14 **A** Yes.

15 **Q** Different than stock options. Is that right?

16 **A** Yes.

17 **Q** But your e-mail refers to the options, as well as the
18 stock -- restricted stock. Is that fair to say?

19 **A** Yes.

20 **Q** And, is it fair to say that you were asking her to go
21 ahead and prepare the stock option letters and agreements for
22 the third quarter?

23 (Defendant examines document)

24 **A** I think right before this time, we receive -- you know,
25 the 2004 plan was passed by the shareholders. So I may just be

1 giving her -- these are the new templates.

2 I don't know if it was an instruction to complete the
3 templates, or whether or not the auditor -- or the attorney
4 sent it me and I'm sending them to her.

5 So, specifically, I'm not sure about that.

6 **Q** Okay. Well, those --

7 **A** And then, she's asking for the schedule.

8 **Q** Sure. The -- those third quarter 2004 grants made it into
9 Equity Edge, right? We saw your e-mail to E*TRADE. Is that
10 right?

11 **A** Okay.

12 **Q** Is it correct to say that Embarcadero didn't take a
13 compensation charge for the in-the-money portion of the third
14 quarter 2004 stock options?

15 **A** Hmm. I believe the only stock option expense we took
16 would have been with respect to the restricted stock awards.
17 The -- the grants were at fair market value, so there was no
18 compensation charge.

19 **Q** Okay. Now, Embarcadero, in the fourth quarter, after the
20 beginning of the revenue recognition investigation, Embarcadero
21 suspended all exercises of stock options by employees in the
22 fourth quarter 2004.

23 Is that right?

24 **A** Probably. Whether it was part of -- I think I've seen
25 e-mails -- it was part of the investigation or just part of the

1 regular quarterly blackout, I don't know, specifically, at this
2 time.

3 **Q** Well, we've seen reference to this in some of the
4 financial statements that we've reviewed with other witnesses.

5 Embarcadero took a compensation -- or, extended the life
6 of the options that were sent to expire in the fourth quarter
7 2004.

8 Is that right?

9 **A** I do recall that, yes.

10 **Q** And because they -- they extended the life of those
11 options, they -- the company took a compensation charge for the
12 modification of those -- those option terms.

13 Is that right?

14 **A** I think it was \$11,000, or something like that.

15 **Q** Right. So, the company recognized a compensation expense
16 associated with the extension of those option terms.

17 Is that right?

18 **A** That's -- that's right.

19 **Q** Okay. And, am I correct in thinking that you worked with
20 the auditors in calculating the \$11,000 that the company
21 recognized, associated with that charge?

22 **A** I -- I -- I believe I did. We'd also brought in another
23 consultant at this time, to help us with that as well.

24 **Q** But is it fair to say that while you're working with the
25 auditors, you and the consultant were working with the auditors

1 on calculating that charge for the extension of those options,
2 that you didn't tell the auditors that the third quarter 2004
3 options had been priced at the low of the quarter?

4 **A** No. We were talking about the extension of terminated
5 employees' exercises.

6 **Q** And you worked with the auditors on the revenue
7 recognition investigation, is that right?

8 **A** I did, yes.

9 **Q** I mean, the auditors were involved in overseeing and
10 looking at the work that the company did to get the bottom of
11 what the problem was in the UK; is that right?

12 **A** Well, as you've heard, I mean, they reviewed the -- the
13 outcome of, you know, our investigation. And audited it.

14 **Q** Did you communicate? I assume you communicated with the
15 auditors, with what you found in the UK? Is that fair to say?

16 **A** I don't know if I did. You know, they brought in Deloitte
17 and Touche, so -- or the Audit Committee did. So, I probably
18 communicated to them, and they wrote a report.

19 I don't know if, specifically, you know, I gave any
20 conclusions. It wasn't my job to give conclusions as to what
21 happened.

22 **Q** Sure. Deloitte and Touche is another audit firm; is that
23 correct?

24 **A** Correct.

25 **Q** And the audit committee hired a separate audit firm to

1 help it with the investigation into the rev rec problems in the
2 UK.

3 **A** Correct.

4 **Q** Is that what you're saying? And you may have had some
5 interaction with the Deloitte and Touche auditors, in
6 connection with their work in getting to the bottom of it.

7 Is that --

8 **A** No, I -- I know I had interaction with them.

9 **Q** And, is it fair to say during all of your work on the --
10 getting to the bottom of the revenue recognition problem, that
11 you didn't tell the PwC auditors at the same time that the
12 third quarter stock options had been priced at the low in the
13 quarter?

14 **A** No. I don't know why, you know, in the middle of a rev
15 rec, we would be talking about stock options.

16 **Q** That's a good point. You -- you testified about having a
17 Super Bowl Sunday office meeting with Betty Jo Charles.

18 Do you recall that testimony? She was in the office,
19 looking, and she discovered the -- the problem with the tax
20 treatment of the pre-IPO stock options.

21 Is that right?

22 **A** Yes.

23 **Q** Is it fair to say that you worked with the auditors to
24 recalculate that, the number of the -- the true compensation
25 expense or the true tax effect for those pre-IPO stock options,

1 in early 2005?

2 **A** The compensation expense didn't change. You know, there
3 was no issue with compensation expense that was taken in the
4 cheap stock. It was only the taxes associated with that
5 compensation.

6 **Q** Sure. But you worked with the auditors in figuring out
7 what the tax effect was on those pre-IPO stock options.

8 Is that right?

9 **A** I did, but it's hard to believe. We actually hired a tax
10 expert to come help us with our tax accounting, because it's
11 such a complex area. So there was another consultant involved,
12 Randy Bradford, who really did most of the legwork on that
13 whole thing.

14 **Q** You were still the controller at the time, right?

15 **A** Yes, I was.

16 **Q** And, the company ultimately published its third quarter
17 results in January, 2005?

18 **A** Yes. Middle of January.

19 **Q** And it published its annual results for January of 2004 in
20 April, I believe. Is that right?

21 **A** That's right.

22 **Q** And those financial statements, both -- both the annual
23 financial statements were audited, is that right?

24 **A** They were.

25 **Q** And the third quarter 2004 results that were filed in

1 January, those were reviewed by the auditors, right?

2 **A** They were, yes.

3 **Q** And, at the time that they were doing the reviews and were
4 audits, you didn't tell them that the third quarter stock
5 options had been priced retroactively, did you?

6 **A** I don't think they were priced retroactively.

7 **Q** Okay. Well, we saw that they were priced on October -- as
8 of August 13th, 2004. Do you recall that, seeing that in the
9 e-mail that you sent to E*TRADE?

10 **A** Yes.

11 **Q** You would agree that Stephen Wong didn't make the
12 decision, on August 13th, 2004, to price those stock options?

13 **A** The -- I would agree with that, but we weren't looking at
14 the date of decision. I mean, we were looking at his
15 authorization. And what he was authorizing.

16 **Q** If I could ask you to turn to Exhibit 61 in your binder.
17 I think Counsel asked you about similar e-mails yesterday.

18 **MR. TASHJIAN:** Your Honor, Exhibit 61 reflects an
19 e-mail exchange between the Defendant and, I believe, some
20 auditors, dated February 23rd, 2005.

21 **BY MR. TASHJIAN:**

22 **Q** Mr. Pattison, you recognize the names on the e-mail
23 exchange? Udit Tibrewal?

24 **A** Yes, I do.

25 **Q** And Saulius Bakas?

1 **A** Yes.

2 **Q** They were PwC auditors at the time?

3 **A** Yes.

4 **MR. TASHJIAN:** Your Honor, I would ask that Exhibit
5 61 be moved into evidence.

6 **THE COURT:** Any objection?

7 **MR. RICHARD:** No. I think you talked about it
8 yesterday, but apparently it's not in, so no objection.

9 **THE COURT:** Okay. Admitted.

10 (Trial Exhibit 61 received in evidence)

11 (Document displayed)

12 **BY MR. TASHJIAN:**

13 **Q** So, if we look at the bottom e-mail, this was an e-mail
14 that we saw in a different exhibit from Udit Tibrewal to you
15 and to Saulius Bakas, on February 23rd (As read):

16 "Hi, Michael, We need to test some of the
17 options for the periods Q1 through Q3 of
18 2004. This includes grants, exercises and
19 cancellations."

20 We looked at a similar e-mail yesterday, is that right?

21 And your response at the top (As read):

22 "Are you kidding??"

23 Do you see that?

24 **A** Yes, I do.

25 **Q** "This is ridiculous." Do you see that?

1 **A** Yes, I do.

2 **Q** The "Regards" I think was an automatic signature for you
3 at the time?

4 **A** No. I erased what I put there, and put "Regards."

5 **Q** The "Are you kidding?? This is ridiculous," those were
6 your words, is that fair to say?

7 **A** I then subsequently followed that with an e-mail to
8 Saulius.

9 **Q** And, we saw some of those e-mails yesterday?

10 **A** Right. So, taken that out of context, looking at the date
11 and the attachments, and the fact that they had already tested
12 Q1, -2 and -3 prior to this, you know, kind of fills in the
13 blanks.

14 **Q** Is it fair to say that in any of the e-mails that we've
15 seen, including this one, that you told -- that you did not
16 tell the auditors that, in fact, the third quarter 2004 grants
17 had been priced at the end of the quarter?

18 **A** That's probably fair to say. It's also fair to say that I
19 did exactly what they asked for.

20 **MR. TASHJIAN:** I've got nothing further. Thank you,
21 Your Honor.

22 **THE COURT:** All right, thank you.

23 Now, normally, ladies and gentlemen, we would proceed
24 with redirect of Mr. Pattison. But because of the scheduling
25 issue we have with a witness who's from out of town, we're

1 going to sort of interrupt -- we sort of did this before --
2 we're going to interrupt -- and I will do a pop quiz again to
3 make sure you are paying attention -- we're going to interrupt
4 the testimony of Mr. Pattison, and allow the Defendant to call
5 their next witness. And then after that, we'll resume. Okay?

6 So, you may step down.

7 **THE DEFENDANT:** Thank you.

8 **MR. RICHARD:** Thank you very much, Your Honor. We
9 will call Professor Kenneth Lehn, L-E-H-N.

10 **THE COURT:** All right.

11 (Witness placed under oath)

12 **THE CLERK:** Thank you. Please be seated, and speak
13 clearly into the microphone.

14 Please state your full name, and spell your last
15 name.

16 **THE WITNESS:** Kenneth M. Lehn, L-E-H-N.

17 **THE COURT:** Thank you. You may proceed, Mr. Richard.

18 **MR. RICHARD:** Thank you, Your Honor.

19 **KENNETH M LEHN, Ph.D.,**

20 called as a witness for the Defendant herein, having been first
21 duly sworn, was examined and testified as follows:

22 **DIRECT EXAMINATION**

23 **BY MR. RICHARD:**

24 **Q** And, good morning.

25 **A** Good morning, Mr. Richard.

1 Q Can you tell us -- by the way, there's some water up
2 there, if you need a cup as we get going here.

3 A Okay, great.

4 Q Can you tell us what your profession is, sir?

5 A I'm a professor of finance.

6 Q And, where are you a professor of finance?

7 A At the University of Pittsburgh.

8 Q And, have you been retained as an expert by the attorneys
9 for Mr. Pattison in this matter?

10 A Yes, I have.

11 Q And before we get to those opinions, it might be helpful
12 to go through your background a little bit.

13 Can you tell us what courses you teach as the professor of
14 finance at the University of Pittsburgh?

15 A Well, I've taught a variety of finance classes, mostly at
16 the graduate level, at the University of Pittsburgh, both in
17 the business school and in the law school.

18 In recent years, most of my teaching has been in the area
19 of business valuation, which encompasses how you value a
20 company, how you estimate the value of the company.

21 Q And are the law school students a little slower than the
22 business school students?

23 A (Laughter) Not at all.

24 Q All right. And, for the courses you teach, are there some
25 common methodologies that you cover when it comes to valuing

1 companies, or the stock of companies?

2 **A** There are. There are a couple of methods that are widely
3 used, both in the academic community as well as in the business
4 communities. And, the most prominent method is referred to as
5 the discounted cash flow method.

6 So, I teach an entire course that teaches students how to
7 use the discounted cash flow method of valuing companies.

8 **Q** And, can you give us just an overview as to what that
9 method -- without getting down into the nitty-gritty, we're not
10 taking your course for credit today.

11 But if you can give us the overview, when you say "the
12 discounted cash flow method."

13 **A** Sure. It's almost universally accepted in the finance
14 profession that the value of a company is equal to the present
15 value of its expected cash flows. And, its cash flows are
16 different from its earnings.

17 So, an important part of that course and an important part
18 of understanding how to value companies is understanding which
19 accounting variables are important and which are not important
20 for purposes of valuing a company.

21 You know, some accounting numbers are more of the
22 bookkeeping variety. They don't really inform you about the
23 economic condition of the company. And when you're valuing a
24 company, you are really trying to value the cash flows which do
25 measure the economic condition of the company.

1 Q Okay. Thank you for that overview.

2 And, do stock options arise in the context of your
3 valuation course work?

4 A They -- they do. Employee stock options represent a claim
5 on the assets of a company. And because those options may be
6 exercised, they potentially will dilute the value of the
7 remaining shares.

8 So when one is trying to value the stock of a company,
9 i.e. estimated stock price, one has to take into account the
10 value of all the outstanding employee stock options. Not just
11 the granted options over some period, but the total number of
12 outstanding options.

13 Q And what's the word you use for that consideration?

14 A Well, I think you're referring to the term "dilution."
15 That employee stock options potentially will dilute the value
16 of the outstanding shares. And for that reason, one has to
17 take that into account when you value a company.

18 Q Okay. And before we talk about accounting variables, and
19 dilution, and how those things are similar or different, can
20 you describe your employment background, beginning with -- have
21 you ever been employed by the United States Securities and
22 Exchange Commission?

23 A Yes. I had two stints with the SEC. From 1984 to 1985, I
24 was Deputy Chief Economist. And from 1987 to 1991, I was Chief
25 Economist.

1 **Q** And, can you describe for us what that entailed, what your
2 responsibilities were as either Deputy Chief Economist or Chief
3 Economist?

4 **A** Well in both positions, I had certain supervisory
5 responsibilities, if you will. And, our office served three
6 roles at the Commission.

7 A very important part of our function was to work with the
8 Division of Enforcement and the regional offices of the SEC.
9 And assist them in enforcement matters.

10 A second part of the position was to oversee the
11 publication of studies that our office would put out, that
12 would be of general interest concerning the operation of
13 securities markets.

14 And then, a third function was to evaluate policy
15 proposals, either proposals from the U.S. Congress or proposals
16 from within the SEC, to regulate securities markets.

17 **Q** And, can you let us know -- when you were Chief Economist
18 for the United States Securities and Exchange Commission, the
19 first area you mentioned was Division of Enforcement. What is
20 the Division of Enforcement?

21 **A** The Division of Enforcement is an office within the SEC
22 that has responsibility for bringing enforcement actions
23 against those that might have violated securities laws.

24 **Q** Enforcement action, like the one that brings us here?

25 **A** Correct. Technically, there are regional offices of the

1 SEC as well. And, organizationally, whether that's part of the
2 Division of Enforcement or not, I don't know.

3 **Q** But for those matters where you were working with the
4 Division of Enforcement, what would your role have been, as the
5 economist?

6 **A** Well, it varied from case to case. But I would say the
7 overwhelming majority of cases were ones in which either I or
8 the office that I directed was asked to determine whether
9 certain information would have been material to investors.

10 **Q** And, when you say "whether information would have been
11 material to investors," what was your understanding of the
12 phrase "material information"?

13 **A** Well, my understanding of "material information" is as
14 follows: Information is material if it is likely that it would
15 significantly alter the total mix of information about a
16 security, and that it is information a reasonable investor
17 would consider in making a decision to buy or sell the
18 security.

19 And that was an understanding that I came to, based on a
20 Supreme Court case.

21 **Q** And was that your understanding of "material information"
22 at the time you worked with the SEC?

23 **A** Yes.

24 **Q** And, can you briefly describe for us -- I don't think I
25 had you do this -- your educational background?

1 **A** Sure. I received a bachelor of arts degree in economics
2 from Waynesburg College, a small school in Pennsylvania, in
3 1975. And then I received a master's of arts in economics from
4 Miami University in Ohio, in 1976.

5 And then, I received a Ph.D. in economics from Washington
6 University in St. Louis, in 1981.

7 **Q** And, have you published any writings, any articles, books,
8 things of that nature?

9 **A** I have. I've edited one book, and published approximately
10 40 articles in academic journals or scholarly books.

11 **Q** And what's the general subject matter of those 40
12 articles?

13 **A** Most of them address issues related to corporate finance
14 or the workings of securities markets. And then, I have a few
15 that look at the economics of Major League Baseball.

16 **Q** Well, let's talk about those.

17 Do any of the publications, other than the ones having to
18 do with Major League Baseball, deal with issues related to this
19 case, as you understand it?

20 **A** None of the publications deal with the specific issue at
21 hand in this matter. But, several of the publications address
22 issues related to how information affects the valuing of
23 company stock.

24 **Q** And what do you mean by that, "how information affects the
25 value of company stock"?

1 **A** Well, how the release of new information would affect a
2 company's stock price, and conditions under which it might, and
3 conditions under which it might not.

4 **Q** Okay. And have you, for any of the professional journals
5 you referred to, have you served as an editor or on any of the
6 boards of those journals?

7 **A** Yes. I've been on the editorial board of approximately
8 six to eight journals. And I also am the founding editor of a
9 journal called *The Journal of Corporate Finance*, which I, along
10 with someone else, started back around 1993.

11 **Q** And what does it mean to be -- what does an editorial
12 board do, of these journals that you've identified?

13 **A** Well, these are journals that are referred to as
14 peer-reviewed journals. And what that means is when people
15 submit the paper to the journal, they ask to have it considered
16 for publication. And the editorial board then will send those
17 papers out to peers, academic peers, who will review the papers
18 and make sure that the papers conform with accepted practice in
19 the profession, and that there's a scientific basis for the
20 conclusion's that they reach.

21 So, it largely is a supervisory role, if you will, to make
22 sure that the quality of the papers is what it should be.

23 **Q** And, for the papers that you've had published, would those
24 have gone through that same peer-review process?

25 **A** Most of them, yes. That's right.

1 Q Okay. Have you ever been retained as an expert witness
2 before?

3 A I have, yes.

4 Q In what types of subject matters?

5 A Well, there have been a variety of matters. But I would
6 say most of them have involved issues related to whether
7 information is material. And specifically, whether it's
8 material to investors.

9 And then, another group of cases has involved an issue
10 referred to as "loss causation," which examines whether alleged
11 misstatements caused losses to investors.

12 Q Have you ever been retained by the United States
13 Securities and Exchange Commission in any of those matters?

14 A I have, yes.

15 Q On about how many occasions has the SEC retained you as an
16 expert in matters of economics?

17 A Somewhere in the vicinity of ten to 12 times.

18 Q And, those would be matters where you would -- the
19 expectation would be that you would be testifying, in
20 deposition or in court?

21 A I can't speak to what the Commission's expectation was,
22 but certainly, in many of those cases, I did testify. Both in
23 deposition and in court.

24 Q And, when you worked with the United States Securities and
25 Exchange Commission, as an expert on issues of materiality in

1 other litigation, did you use a different definition of
2 "material information"?

3 **A** No. I, in those matters was asked by the SEC to assume
4 the same definition that I'm assuming in this matter.

5 **Q** Okay. Have you worked with any other branches of the
6 federal government, as an expert?

7 **A** I've also been retained by the Department of Justice,
8 maybe five or six times.

9 **Q** Would you say there's any relationship between the matters
10 you worked on for either the SEC and the Department of Justice
11 and the matter that brings you here?

12 **A** Yes. Most of the matters with the Department of Justice
13 involved the issue of whether or not information was material.
14 And as best as I can recall, all of the matters that -- on
15 which I have been retained by the SEC have been matters in
16 which I have been asked to form an opinion as to whether
17 information was material.

18 **Q** When the SEC retains you, are you paid?

19 **A** Yes, I am.

20 **Q** And, are you being paid for your time here today?

21 **A** I am, yes.

22 **Q** Can you tell us what it was you were asked to do in this
23 particular matter?

24 **A** I was asked to analyze the economic evidence concerning
25 the materiality of the accounting expenses that are at issue in

1 this matter.

2 **Q** And sir, can you give us an overview -- did you reach any
3 conclusions in that regard?

4 **A** I did, yes.

5 **Q** And what -- what, in general, are your conclusions in this
6 matter?

7 **A** I have three conclusions.

8 The first conclusion is that Embarcadero's SEC filings
9 contained all of the relevant information that investors would
10 want to know in order to assess the effect that Embarcadero's
11 employee stock options would have on the value of its stock,
12 and hence, its stock price.

13 Second, I concluded that market participants would not
14 have obtained any additional relevant information about the
15 impact of the employee stock options on its stock price --
16 Embarcadero's stock price -- if Embarcadero had used the
17 allegedly proper methodology for accounting for stock options.

18 And then, third, the economic evidence, in my opinion,
19 does not support the SEC's allegation that the alleged
20 misstatements in this matter were materially misleading.

21 **Q** Okay. Let's talk about your first opinion, if we could,
22 sir.

23 In general, do stock options affect the value of a
24 company's stock?

25 **A** They do, yes.

1 Q And, is it that concept of dilution you alluded to
2 earlier?

3 A That's correct.

4 Q Can you explain to us -- we've heard the phrase "dilution"
5 in this case.

6 Can you explain for us, from the perspective of an
7 economist looking at the economic evidence, what information
8 would one need to know about the employee stock options to make
9 that evaluation of dilution or potential dilution?

10 A Well, the information about the stock options that one
11 would need to know is, what is the exercise price of the
12 options; how much time is left before the options expire, which
13 is sometimes referred to as the remaining contractual life.

14 And then third, you would need to know how many options
15 are outstanding. Not just the number that were granted over
16 some period of time, but the total number of options that are
17 outstanding.

18 Q Can you explain that difference between options
19 outstanding and options granted, briefly?

20 A Sure. In any given point in time, there's a total amount
21 of options outstanding. And then over a course of some time,
22 let's say a year, a company may grant new options. And, you
23 would then add those newly-granted options to those that were
24 outstanding at the beginning of the period.

25 And then also during the course of the year, some options

1 will be exercised, which means they're converted from options
2 to stock. So you would subtract the amount that are exercised.

3 And then finally, there are some options over the course
4 of the year that are cancelled. And you would then subtract
5 those cancelled options as well.

6 So, the bottom line is that over the course of a year, you
7 would have to adjust the outstanding options at the beginning
8 of the year for those options granted, those options exercised,
9 and those options cancelled.

10 **Q** Okay. And -- thank you.

11 And with respect to the information about the exercise
12 price of the outstanding options, and the time left -- what you
13 called the remaining contractual life of those options, and
14 then the number of options outstanding, based on material you
15 reviewed, did Embarcadero Technologies disclose that
16 information to its shareholders or investors?

17 **A** Yes. All of that information was disclosed in its 10-K
18 filings.

19 **Q** Do you have a binder there in front of you, sir?

20 **A** I do.

21 **Q** One of the exhibits in this case that I believe is already
22 in evidence is Exhibit 401. The annual report for the year
23 2000.

24 Is this one of the documents you reviewed in this matter?

25 (Document displayed)

1 (Witness examines document)

2 **A** Without vouching for every page, it appears to be, yes.

3 **Q** And, where would we find the information about the
4 exercise prices, remaining contractual life, and number of
5 outstanding options in this particular 10-K from Embarcadero
6 Technologies from the year 2000?

7 (Witness examines document)

8 **A** Yeah, that would appear on Page 46.

9 **Q** Okay.

10 **MR. RICHARD:** Can we find that, Jonathan? I think
11 it's up at the top there. Thank you.

12 (Document displayed)

13 **MR. RICHARD:** And now, can you go back to the
14 preceding page? And there's a heading that will need to carry
15 over, I think, where it says "Options Outstanding, Options
16 Exercisable."

17 (Document displayed)

18 **MR. RICHARD:** Right.

19 **BY MR. RICHARD:**

20 **Q** Would it be helpful if we put all of that on the same
21 page?

22 **A** Sure.

23 **MR. RICHARD:** Okay. Is that something you can cut
24 and paste, Jonathan?

25 (Document displayed)

1 **MR. RICHARD:** Some of that's a little small. I don't
2 know if you can all see that.

3 Maybe you can enlarge just the heading up there,
4 "Options Outstanding, December 31st, Weighted."

5 Went away.

6 (Document displayed)

7 **MR. RICHARD:** There we go. Okay. Then as we go
8 through it, Jonathan, I may have you blow up the various
9 headings. But, let's get into the discussion.

10 **BY MR. RICHARD:**

11 **Q** Can you explain what it is we're looking at in this annual
12 report filed with the SEC for Embarcadero Technologies for the
13 year 2000?

14 **A** Sure. And again, the three pieces of information that one
15 would need to know about the option in order to estimate the
16 effect of the options on the stock price would be first, the
17 number of options that are outstanding.

18 **Q** Do you want to use the little pointer?

19 **A** Sure.

20 **Q** I would do it, but --

21 **A** Try to shoot all the way across there?

22 **Q** Let's see, if you can't do it --

23 **A** There we go (Indicating).

24 **Q** There we go. Bulls-eye.

25 **A** That's the total number of options outstanding as of the

1 end of the year 2000. And, it's 3,944. But those numbers are
2 expressed in thousands, as you see up there (Indicating), so
3 3,944 actually represents 3.944 million options outstanding as
4 of December 31st, 2000.

5 **Q** Okay.

6 **A.** The second piece of information is the exercise price.
7 And you see right there this column here is the
8 weighted-average exercise price. And it gives you that
9 weighted-average exercise price for all of the options. And
10 the total at the bottom is 10.01.

11 And then it breaks it out in a more granular way for
12 different options with different exercise prices.

13 **Q.** And can you explain that for us?

14 **A.** Sure. What -- what Embarcadero has done here, and what
15 companies typically do, is they not only give you information
16 about all the options, but then they break it down into ranges
17 of exercise prices.

18 So here they're telling you there's a group of options
19 that have an exercise price of 5 cents. There are 175,000 of
20 them. They have a remaining contractual life of 7.2 years.
21 And they have a weighted-average exercise price of 5 cents.

22 And then you go down to the next one. It tells you there
23 are options with an exercise price of 25 cents, and the same
24 type of information.

25 Then there's a group of options with exercise prices

1 between 50 cents and a dollar twenty-five. And they give you
2 that information.

3 And, of course, all of that information ultimately totals
4 to one grand number down here. So they give you the total
5 number, but then they give you a more granular description of
6 the options.

7 So they tell you the total number of options, which you
8 need. They tell you the weighted-average exercise price, which
9 you need. And then they also tell you the weighted remaining
10 contractual life; how much time is left before the options
11 expire.

12 And those are the three pieces of information about the
13 option that an investor would need to know in order to
14 determine the impact that the options have on the company's
15 stock price.

16 **Q.** And can you explain that for us?

17 **A.** Well, again, the options may be exercised. And when
18 they're exercised, they will dilute the value of the
19 outstanding shares.

20 And there are ways to assess the value of the options.
21 And the three variables about the options that are necessary to
22 assess their value are the number of options; the
23 weighted-average exercise price; and the weighted remaining
24 contractual life.

25 And all of those are disclosed in Embarcadero's 10-Ks.

1 Q. And why is it that, if stock options are actually used and
2 changed from a potential an actual share of stock -- why would
3 that -- when you say "dilute" the value, what is the thought
4 behind that?

5 A. Well, when the holder of an option exercises the option,
6 they receive shares in exchange for their option. So they will
7 pay the exercise price to the company, and then they will get a
8 newly issued share.

9 So when options are exercised, that increases the number
10 of shares that will be outstanding. And that means,
11 effectively, that there is less value for the other
12 shareholders, because the equity value of the company is now
13 being divided among a larger number of shares.

14 Q. And if one wanted to determine what the likelihood is of
15 the exercise price, an economist would look at this type of
16 information -- or an investor -- and make that determination?

17 A. Yes. There's a -- there are a number of option pricing
18 models, but the most prominent is one referred to as the
19 "Black-Scholes model."

20 And Black and Scholes developed a way to price options in
21 the early 1970s. And Scholes won a Nobel prize for it. It's
22 been widely recognized; widely embraced by not only the
23 academic community, but the business community. And
24 individuals can actually use Black-Scholes. There's a
25 Black-Scholes app. for your iPhone. And you can --

1 **MR. RICHARD:** I don't have that one. Oh, that's
2 because I don't have an iPhone, but --

3 **THE WITNESS:** You can use it in E*Trade. It's a
4 complicated formula, but it's very easy to use. It's sort of
5 like: Understanding how to amortize your mortgage might be
6 complicated, but you can plug numbers in your computer and get
7 a very good estimate of that.

8 So the Black-Scholes model is widely used, and
9 certainly used by investment professionals that follow
10 companies and issue reports on companies.

11 And the three variables that are necessary in
12 Black-Scholes to estimate the value of the outstanding
13 options -- the three variables about the option are the number,
14 the exercise price, and the remaining contractual life.

15 And, as Mr. Richard describes, essentially the reason
16 those variables play a role is they tell you something about
17 the likelihood that the options will be exercised.

18 **BY MR. RICHARD:**

19 **Q.** Have you looked at Embarcadero's annual reports for other
20 periods?

21 **A.** Yes, I have. In addition to the Year 2000 10-K, I also
22 looked at the 10-Ks for 2001 through 2005.

23 **Q.** And is the same information regarding -- the same
24 information from which a reasonable investor could calculate
25 the impact of the outstanding stock options in the other annual

1 reports?

2 **A.** Right. The numbers, of course, are different year to
3 year, but the very same type of information is disclosed in the
4 other 10-Ks as well.

5 **Q.** And do you have Exhibit 225 in the binder in front of you,
6 sir?

7 **A.** I have a 225A.

8 **Q.** This should be towards the back. It's -- well, I'm not
9 sure what it is.

10 **THE COURT:** 225A is the tab. I don't know if that's
11 the same thing.

12 **MS. LAMARCA:** It doesn't have it.

13 **MR. RICHARD:** Yeah. It should be in your binder
14 towards the back, right before Exhibit 434, your Honor, as we
15 get into the --

16 **THE COURT:** The 434?

17 **MR. RICHARD:** Right. After 4-1; the one we were just
18 looking at.

19 **THE COURT:** I don't have it.

20 **THE WITNESS:** 225A here?

21 **THE COURT:** My binder is 225A.

22 **MR. RICHARD:** Sorry about that. I thought these were
23 extras. Here's one for your Honor.

24 **THE COURT:** I have it.

25 **MR. RICHARD:** Very good.

1 **THE COURT:** It says "225A."

2 **MR. RICHARD:** That's what I keep trying to say on the
3 record: 225A, which are the pages from the various 10-Ks.

4 **THE COURT:** That is in the binder. Not 225. 225A.

5 **MR. RICHARD:** 225A.

6 **BY MR. RICHARD:**

7 **Q.** Can you tell us, sir, what 225A represents?

8 **A.** In 225A contains the similar disclosures that were made by
9 Embarcadero in 10-K filings for years 2001 through 2004.

10 **Q.** So these are portions from the 10-Ks that were filed with
11 the SEC?

12 **A.** That's correct.

13 **MR. RICHARD:** And, your Honor, we'd move this
14 collection into evidence as 225A.

15 **THE COURT:** Any objection?

16 **MS. LAMARCA:** We note that these are already in the
17 record but we don't object to this compilation.

18 **THE COURT:** All right. So it is a compilation of
19 different years. Is that what it is?

20 **MR. RICHARD:** Yes, your Honor.

21 **THE COURT:** All right. No objection. Then 225A will
22 be admitted.

23 (Trial Exhibit 225A received in evidence)

24 **MR. RICHARD:** Thank you.

25

1 **BY MR. RICHARD:**

2 **Q.** And, rather than go through each of those years, let me
3 ask you, sir. Are you familiar with the term "intrinsic value"
4 as it applies to employee stock options?

5 **A.** Yes.

6 **Q.** And in general, can you tell us what your understanding of
7 the term "intrinsic value" is for employee stock options?

8 **A.** Sure. If the stock price of a company is greater than the
9 exercise price of the option, the intrinsic value of the option
10 is simply the difference between the stock price and the
11 exercise price.

12 So, for example, if a company's stock price is \$10, and
13 the exercise price of the option is \$8, the intrinsic value
14 would be \$10 minus \$8, or \$2.

15 And the information that conveys is that if the holder of
16 the option were to exercise it today, they would pay \$8. The
17 stock is worth 10, so they would make a profit of \$2.

18 So effectively, the intrinsic value is telling you
19 something about the profitability of exercising the option if
20 the option was exercised today.

21 If the stock price of a company is equal to the exercise
22 price, the intrinsic value is zero. So if the exercise price
23 is \$10, and the stock price is \$10, then there is no profit.
24 \$10 minus \$10 is zero.

25 And if the stock price is less than the exercise price,

1 the intrinsic value is zero, on grounds that if the stock price
2 was less than the exercise price, you wouldn't exercise the
3 option, so you wouldn't make a profit.

4 So if the stock price is \$8, and the exercise price is
5 \$10, the intrinsic value would be zero.

6 **Q.** Okay. And so what are the two pieces of information -- or
7 what would I need to know if I wanted to determine the
8 intrinsic value of my options on any given day?

9 **A.** Yeah. On any given day, there are only two pieces of
10 information you need to know to calculate intrinsic value. You
11 need to know the exercise price of the option, and you need to
12 know the stock price on that day.

13 **Q.** Wouldn't I need to know when the option was first
14 approved?

15 **A.** No. That would be completely irrelevant.

16 **Q.** Wouldn't I need to know when the option was issued?

17 **A.** No. That also would be irrelevant.

18 **Q.** How about when the option was born?

19 **A.** No. Never heard that expression, but that would not be
20 relevant as well.

21 **Q.** All right. Have you prepared something so we can follow
22 this a little bit easier, rather than me fumbling through?

23 **A.** I have.

24 **Q.** Can we take a look at -- I think it should be in your
25 binder -- Exhibit 915? It should be the first slide. Yeah.

1 There we go.

2 So we're looking at a slide on the screen that -- can you
3 just -- I think you've just explained this for us. Can you
4 briefly walk us through these different examples? You have
5 on -- you know, why are you talking about current information,
6 and measurement date, or historic information?

7 **A.** Sure. This is just a -- an illustrative example of why it
8 doesn't matter what the status of the option was at the time it
9 was granted for determining the intrinsic value at some later
10 date.

11 So, if you focus on the right side of the chart, you see
12 we have three options there. Each row is a different option.
13 And you see that, based on current information, the company's
14 stock price is \$40. That's this column right here. So \$40.
15 And you see that the exercise price of the three options is
16 identical. Each of them has an exercise price of \$30. So the
17 intrinsic value today is \$10. And that's true for each of the
18 three options.

19 And whenever the stock price is greater than the exercise
20 price, we claim that the option is in-the-money. So, as of the
21 current information, all three options are in-the-money. And
22 all three have the same intrinsic value of \$10.

23 Now, if we go to the left-hand side of the chart, we see
24 that the stock price of this company was different when the
25 options were initially granted, based on the measurement date

1 that we have up here. So you see, again, all three have
2 exercise prices of \$30, but the first one was issued at a time
3 when the stock price was \$10. The second one was issued when
4 the stock price was \$30. And the third one was issued when the
5 stock price was \$50.

6 And so the first one was out-of-the-money when it was
7 issued. The second was in-the-money. And the third -- I'm
8 sorry -- was at-the-money. And the third was in-the-money.

9 But none of that information -- none of the information
10 about the status of those options at the time they were granted
11 is relevant for calculating the subsequent intrinsic value.

12 The only thing that affects the intrinsic value later is
13 what the stock price of the company was later, in comparison to
14 the exercise price. How the stock price compared to the
15 exercise price at some earlier date is completely irrelevant.

16 **Q.** Okay. And could the investors of Embarcadero have
17 estimated that intrinsic value of Embarcadero's outstanding
18 stock options on any particular date, by using that information
19 you've already told us about?

20 **A.** Yes. All of the information to calculate the intrinsic
21 value was disclosed in Embarcadero's 10-K filings.

22 **Q.** Okay. And did you prepare a slide that can explain that
23 to us?

24 **A.** Yes.

25 **Q.** I think it's Slide 916. Can you tell us what this is,

1 sir?

2 **A.** Yes. This is an example of how an investor would be able
3 to calculate the intrinsic value based on the disclosures that
4 Embarcadero made. And this information is identical to the
5 information that we saw earlier from Embarcadero's 2000 10-K.

6 **Q.** Mm-hm.

7 **A.** And you see over on the far left, it tells you the source.
8 It's the 2000 10-K. Embarcadero filed this with the SEC on
9 March 20th of 2001. And Embarcadero's stock price on
10 March 20th, 2001, closed at \$15 and 87 and a half cents; so
11 15.875. That was its stock price when the market first
12 received this information.

13 What I then did was I took the information from the 10-K
14 that tells you how many options are outstanding. And it tells
15 you the weighted-average exercise price for the different
16 ranges of exercise prices.

17 And then all I did was I calculated the intrinsic value
18 for each group of options. I just took the stock price of \$15
19 and 87 and a half cents, minus the weighted-average exercise
20 price of .05: 5 cents. That gives you an intrinsic value per
21 option of \$15 and 82 and a half cents.

22 So this column is simply the stock price on the filing
23 date, minus the weighted-average exercise price. And then the
24 intrinsic value of \$15 and 82 and a half cents times the number
25 of options -- 175,000 -- gives you an intrinsic value for this

1 range of \$2.769 million.

2 And then you do the same for each other set of options.
3 You're always taking the difference between the stock price and
4 the weighted-average exercise price, multiplied by the number
5 of options. That gives you the intrinsic value.

6 When you get down to this range of options, you see the
7 intrinsic value is zero, simply because the weighted-average
8 exercise price is now higher than the stock price.

9 And then, to get a sum of the intrinsic value for all of
10 the options, you just add up this very last column. And you
11 see that as of 2000, an investor would be able to determine
12 that the intrinsic value of the outstanding employee stock
13 options was approximately \$38 million.

14 **Q.** And you did that calculation for March 20th, 2001. Could
15 you have done that for some date -- some other date?

16 **A.** Sure. The only thing, again, you'd have to update is the
17 stock price. The weighted-average exercise prices would remain
18 the same. And, as the stock price of the company changed, then
19 the intrinsic value would change.

20 **Q.** Okay. So, based on your review of the economic evidence
21 from Embarcadero's own filings, did Embarcadero hide the fact
22 that it had millions of options outstanding at the end of any
23 given year?

24 **MS. LAMARCA:** Objection, your Honor.

25 **THE COURT:** Grounds?

1 **MS. LAMARCA:** Pardon? The grounds are that this is
2 beyond the expert's report; whether the company hid the fact
3 that -- how it had a certain number of options outstanding.

4 **THE COURT:** All right. Why don't you rephrase the
5 question?

6 **MR. RICHARD:** Sure.

7 **BY MR. RICHARD:**

8 **Q.** Could a reasonable investor have determined from the
9 information you just walked through whether the company had
10 millions of stock options outstanding?

11 **A.** Yes, they could have, rather easily.

12 **Q.** Okay. Could a reasonable investor have determined under
13 the methodology you've just described for us that those
14 outstanding unexercised options were potentially worth tens of
15 millions of dollars?

16 **A.** Yes, they could have.

17 **Q.** That's what I meant by "it wasn't hidden from the
18 investors," right?

19 **A.** I understand. Correct.

20 **Q.** Okay. So let's shift gears. You talked about accounting.
21 I think you called them "accounting variables."

22 I want to ask you some questions about stock-based
23 compensation. In general, can you give us your understanding
24 of what stock-based compensation is?

25 **A.** Sure. Stock-based compensation expense is an accounting

1 entry that companies record on their financial statements when
2 they grant options to employees.

3 **Q.** Okay. And does that expense reflect any cash expenditure
4 by the company at that point in time?

5 **A.** No. Stock-based compensation expense is a noncash
6 expenditure.

7 **Q.** So, from an economic-materiality point of view, is a
8 dollar of stock-based compensation expense the same as a dollar
9 that's spent on something else?

10 **A.** No. A cash expenditure is an expenditure that reduces the
11 cash that a company has. And at the end of the day, the value
12 of the company is the present value of the cash flows that it's
13 expected to generate.

14 So if a company, for example, goes to Office Depot and
15 buys \$100 of pens, and writes a check for \$100, that represents
16 a cash outflow of cash leaving the firm.

17 If a company records a stock-based compensation expense of
18 \$100, no cash leaves the firm. It's -- it's not a cash
19 expenditure, and it doesn't convey information about the
20 underlying economic condition of the firm.

21 **Q.** Well, is there some relationship between the historic
22 compensation expense that a firm would record, and the
23 intrinsic value of the stock options you've been telling us
24 about?

25 **A.** There's no relation whatsoever that -- the historical

1 stock-based compensation expense has no correspondence to
2 subsequent intrinsic value of the options, which is what
3 investors want to know.

4 **Q.** And have you prepared a slide that can briefly illustrate
5 that point for us?

6 **A.** I do.

7 **Q.** I think it's Slide -- what is it? 917? Is that right?

8 **A.** That is correct.

9 **Q.** And can you give us an overview? I think you've made the
10 point, but tell us what it is you're showing on Slide 917.

11 **A.** Well, again, this is similar to the first slide, where we
12 have these three options, all with the same exercise price of
13 \$30.

14 **Q.** Mm-hm.

15 **A.** And the current information shows the company's stock
16 price is \$40. So the intrinsic value on this date of all three
17 options is \$10.

18 Now, you might recall from the first slide that this first
19 option had an exercise price of \$30, but the company's stock
20 price was \$10 at the time it was granted, which means that that
21 was an out-of-the-money option, and there would be no
22 compensation expense recorded, because the intrinsic value,
23 when granted, was zero.

24 The second option has an exercise price of 30. And when
25 it was granted, its stock price was 30. So its intrinsic value

1 at the time it was granted was zero, and therefore, its
2 compensation expense would have been zero.

3 And then, finally, the last one was the option which had
4 an exercise price of 30, but it was granted when the company's
5 stock price was 50, so the intrinsic value of the this option
6 at the time of grant would have been 20, and the required
7 compensation expense on the income statement would have been a
8 \$20 compensation expense.

9 But again, recall that at a subsequent date, the intrinsic
10 value of each of those options is \$10, which means that
11 whatever the compensation expense is, measuring the intrinsic
12 value at some earlier date is completely irrelevant. What
13 matters later is the relation of the company's stock price to
14 the exercise price.

15 And again, the intrinsic value for all three is \$10 at the
16 later date, even though they had different compensation expense
17 reported on their income statement.

18 **Q.** So can you put this in the context for us? Assume that
19 Embarcadero awarded some stock options in 2003 with an exercise
20 price tied to the company's stock in July 2003, so that the
21 exercise price and the company's stock would have been the
22 same --

23 **A.** Mm-hm.

24 **Q.** -- as reflected in the stock option agreement. Are you
25 with me?

1 **A.** I am.

2 **Q.** Can you walk us through the relationship between the
3 intrinsic value of those stock options going forward, and the
4 company's stock price compared to the compensation expense
5 you've been talking about? And do you have an exhibit so we
6 don't have to do it twice?

7 **A.** Right. There is an exhibit in the -- in the notebook
8 here.

9 **Q.** Okay. Can we look at Exhibit 918? So, in general, tell
10 us what's going on with this illustration.

11 **A.** Well, what you see here is how the intrinsic value of a
12 group of Embarcadero options changed over time. And if you
13 look at the horizontal axis of this line right down here
14 (indicating), that's just giving you different dates. So it
15 begins over on the far left here -- July 2nd, 2003 -- and it
16 goes all the way out to April 2nd, 2007. Actually, a little
17 beyond that, to May of 2007.

18 The vertical axis -- this line that goes up and down --
19 measures the intrinsic value of these options on these
20 different dates.

21 And these options have an exercise price of \$6.79. And
22 that exercise price was established based on Embarcadero's
23 stock price on July 1st, 2003. So Embarcadero's stock price on
24 that date was \$6.79, which means the intrinsic value of those
25 options on that date were zero, because the stock price was

1 \$6.79; the exercise price was \$6.79. So you can see that the
2 intrinsic value on that date is zero.

3 You see that over time, the intrinsic value starts to
4 increase. And it increases substantially over \$3 million.

5 And the reason for that increase is that Embarcadero's
6 stock price was rising. The exercise price isn't changing.
7 And, again, the intrinsic value is just the difference between
8 the stock price and the exercise price. So as Embarcadero's
9 stock price increases the intrinsic value of these options
10 increases.

11 And then you see the intrinsic value decreases. And the
12 reason the intrinsic value decreases is that the stock price
13 now is falling. And --

14 **Q.** So, yeah. Let me stop you there.

15 So from your perspective, assume that the SEC is claiming
16 that the company should have recorded a compensation expense of
17 \$1.34 million for these -- this batch of stock options. Would
18 that compensation expense tell a reasonable investor anything
19 about the intrinsic value of those stock options at any
20 particular point in time?

21 **A.** Absolutely not. And that compensation expense is that
22 red, dotted line. And you see that it appears. There's maybe
23 only one day during this whole period where the intrinsic value
24 of these options would be equal to the compensation expense
25 that is being claimed; but on every other day, you see that the

1 intrinsic value is different than that compensation expense
2 number. And that's why the compensation expense number on the
3 income statement conveys no information to investors about the
4 impact of the employee stock options on the company's stock
5 price. And that's why that information is simply not material
6 to investors.

7 **Q.** Okay. If we had more time, I guess we could prepare for
8 the quiz with additional materials, but let's move on as we
9 approach the lunch hour.

10 You've told us about intrinsic value. We've talked about
11 a historic compensation expense for this noncash item. Are you
12 familiar with the term "time value," as it applies to stock
13 options?

14 **A.** I am, yes.

15 **Q.** And, in general, what is time value?

16 **A.** Time value is additional value that an option may have,
17 simply because the stock price may increase further, in which
18 case the intrinsic value of the option would increase.

19 **Q.** So can an option that has no intrinsic value have time
20 value?

21 **A.** It can, because even though it may not have intrinsic
22 value today, it may have intrinsic value some time over the
23 life of the option, as the company's stock price increases.

24 **Q.** And have you heard of the term "fair value" in connection
25 with employee stock options?

1 **A.** Yes. Fair value is simply the sum of intrinsic value and
2 time value.

3 **Q.** So what's the relationship between fair value and
4 intrinsic value?

5 **A.** Fair value will always be greater than or equal to the
6 intrinsic value.

7 **Q.** Okay. So I think you told us that intrinsic value of a
8 stock option doesn't depend on the price of the underlying
9 stock on the day the stock option was approved, issued, or
10 granted. Did I get that right?

11 **A.** That's correct.

12 **Q.** Does the time value of an employee stock option on any
13 particular date depend in any way on what the price of the
14 company's underlying stock was on the date of approval, grant,
15 or issuance?

16 **A.** No, not at all.

17 **Q.** And can you explain that?

18 **A.** Well, again, in estimating the fair value of the options,
19 one wants to know what the exercise price is and how much
20 remaining contractual life there is. One then wants to know
21 what the stock price is on the date that you're trying to value
22 the option, and what the stock price was at any earlier date.
23 Whether it be a grant date, a measurement date, an approval
24 date, is completely irrelevant. The only thing that matters on
25 the day you're trying to value the option is: What is the

1 stock price on that day?

2 **Q.** Did the company disclose information regarding the fair
3 value of its outstanding stock options?

4 **A.** Yes, it did.

5 **Q.** And do we find that also in the -- I think we looked at
6 Exhibit 401, which is the complete annual 10-K for the year
7 2000. Do you have that in front of you still? It looks like
8 on page 47, there's a section actually entitled, "Fair Value
9 Disclosures." Is that where we might find the fair value
10 disclosures?

11 **A.** That's correct.

12 **Q.** Okay. So there we go. So can you just explain to us
13 what -- what this additional information tells us about the
14 employee stock options?

15 **A.** Sure. What Embarcadero did in this disclosure was they
16 provided information about its estimate of the fair value of
17 options that were granted to employees during that year. And
18 they provide that -- you can see this header is "Fair Value
19 Disclosures." And then they provide information about how the
20 net income of the company would have been affected if the
21 fair-value number had been entered as a compensation expense on
22 the income statement. So it's clear as can be for investors to
23 see the impact of the fair value of the option grants on the
24 net income of Embarcadero.

25 And then on the next part of page 47 -- so the second page

1 in the notebook binder -- it provides you with the information
2 that went into its estimate of the fair value. And then it
3 ends by telling you what the weighted average per share fair
4 value of common stock options granted were during 1998, 1999,
5 and 2000.

6 So it's giving you the fair value divided by the number of
7 shares, so that shareholders could see the per-share impact of
8 those fair value -- the fair value of the option grants.

9 **Q.** So from your perspective, what additional information does
10 the fair-value calculation, including the *pro forma* numbers
11 that we see here, provide over the intrinsic value that you
12 talked about earlier?

13 **A.** Well, again, the fair value is going to be larger than the
14 intrinsic value, because the fair value is the intrinsic value
15 plus the time value. So this is actually a larger number than
16 the intrinsic value that allegedly should have been reported on
17 the income statement.

18 **Q.** Okay. And are you familiar with a study published by the
19 Congressional Budget Office that pertains to stock options?

20 **A.** I am, yes.

21 **Q.** And can you tell us --

22 **MR. RICHARD:** You can take that down.

23 **BY MR. RICHARD:**

24 **Q.** Can you tell us briefly: What is the Congressional Budget
25 Office?

1 **A.** The Congressional Budget Office is an arm of Congress that
2 publishes studies and projects budget deficits, and, in the
3 past, budget surpluses.

4 **Q.** And sometimes referred to as "the CBO"?

5 **A.** Correct.

6 **Q.** Did you have any dealings with the CBO while you were with
7 the SEC?

8 **A.** I had some interaction with CBO when I was at the SEC,
9 yes.

10 **Q.** Okay. And can you describe that briefly?

11 **A.** Well, the CBO would often do studies for congressmen and
12 senators. And while I was at the SEC, there were some
13 issues -- like corporate takeovers, and the stock-market crash
14 of 1987 -- that were big issues. And my recollection is that I
15 had interaction with the Congressional Budget Office on some of
16 those issues.

17 **Q.** Now, with he respect to the CBO study on employee stock
18 options, did that provide any comfort or input for the opinions
19 you've shared with us here today?

20 **A.** I wouldn't necessarily say comfort or input; but it's
21 certainly consistent with -- with my testimony today, where the
22 Congressional Budget Office evaluated a proposal by the
23 Financial Accounting Standards Board to require fair-value
24 disclosures to be on the income statement.

25 And, in a nutshell, what they concluded was that if

1 markets are efficient, which we presume they usually are, that
2 all of the information that's in the footnotes should already
3 be reflected in the company's stock prices, and then adding
4 additional information on the income statement would not add
5 any value relevant information to investors.

6 In addition to proffering that statement, the
7 Congressional Budget Office evaluated a number of studies. And
8 their conclusion from the studies were that change in the
9 accounting rules to require more compensation-based
10 expenditures to be put on the income statement would likely
11 have no impact on the company's stock prices.

12 **Q.** Okay. Assume that a suggestion's been made in this case
13 that -- "but the income statement would be affected by the
14 amount of this noncash compensation expense; therefore, it
15 would impact earnings. Doesn't that tell us that it is
16 material?" Would you agree with that?

17 **A.** Not at all. And again --

18 **Q.** Why not?

19 How's that for drama before we go to lunch?

20 **A.** As I indicated before, you know, not all accounting
21 information is relevant for the valuation of companies; that
22 there is a fair amount of accounting information that is more
23 of the bookkeeping variety; that things have to be in order,
24 but they don't really tell you anything about the economic
25 condition of the company; namely, its ability to generate cash

1 flows, which is really what's going to drive the value of the
2 company. And this is one of them.

3 And even if cosmetically the earnings were to become more
4 negative or even if they went from positive to negative, it
5 would have absolutely no bearing on the value of the company's
6 stock.

7 **Q.** And is there any literature that supports your firm
8 observation in that regard?

9 **A.** There is, you know, an abundant academic literature that
10 addresses these issues in general; and some that address the
11 issue of employee stock options, showing that the market does
12 pay attention to the footnote disclosures; and then, more
13 generally, a large literature in finance and accounting that
14 talks about accounting numbers that do matter, and accounting
15 numbers that don't matter.

16 **Q.** And can you take a look at Slide 919 that you prepared,
17 and tell us what this means with respect to this relationship
18 between a company's earnings and their stock price?

19 **A.** Well, this is just one of many examples that one could
20 point to, but it's an article by three prominent accounting
21 professors -- Kinney, Burgstahler, and Martin -- in the *Journal*
22 *of Accounting Research*, December 2002. And it reads, quote,

23 "45 percent of firms' earnings
24 surprises are associated with returns with
25 the opposite sign."

1 Closed quote.

2 And what that means is that when companies announce
3 earnings, there is often a so-called "surprise element" to the
4 announcement. And the way the surprise is measured is you look
5 at what the analysts were forecasting, and then you look at the
6 difference between what the company actually reports in
7 comparison to what the analysts were forecasting.

8 So if the company reports earnings of 50 cents a share,
9 and the analysts were forecasting 40 cents a share, that would
10 be viewed as a positive surprise.

11 If a company reports 30 cents a share, and the analysts
12 have been forecasting a 40 cents a share, that would be a
13 negative surprise.

14 Academics have looked at how companies' stock prices react
15 to unexpected earnings. And what you find is that often, when
16 there's a positive surprise, there is a negative effect on the
17 stock price. And often, when there's a negative surprise,
18 there's a positive effect on the stock price.

19 So -- and the reason is that -- often, the reasons for
20 these surprises have nothing to do with the economic condition
21 of the firm. Every firm --

22 **Q.** Can you explain that, when you refer to the "economic
23 condition of the firm," in relationship to its reported
24 earnings?

25 **A.** Sure. You know, a good example is: Often announcements

1 of write-downs of assets.

2 So you all probably recall that during the so-called
3 "Tech Bubble," there were a lot of internet stocks that had
4 risen in value. And then, with the stock market decline in the
5 early part of the millennium, a lot of these values fell
6 dramatically. And there were a lot of companies that had
7 Internet properties. And when they reported their earnings,
8 they would take write-downs to reflect the fact that the value
9 of those properties had declined.

10 The market had already recognized that. And so when
11 companies would take these charges, their earnings would often
12 fall dramatically. And yet the market was -- would often
13 ignore it; sometimes would actually react positively. Even
14 though the earnings were coming down, it might react positively
15 because it recognized that already. And it didn't think that
16 that write-down had any bearing on the future prospects of the
17 company.

18 So in that way, one has to be very discriminating in
19 understanding how earnings are related to stock prices.
20 There's not a mechanical one-for-one relation between earnings
21 and stock-price movements.

22 **Q.** And when you refer to "future prospects of the company,"
23 what are you referring to, in general?

24 **A.** The ability of the company to generate future cash flows.

25 **Q.** Okay. And are you saying that not every accounting

1 bookkeeping entry provides economic information on the
2 prospects of future economic cash flows?

3 **A.** That's correct.

4 **Q.** Okay. I'd like to switch gears very briefly, if we could.

5 We've heard testimony in this case about certain
6 disclosures that were made in 2006 -- late 2006 -- regarding
7 whether the company could timely file its required 10-Ks; its
8 quarterly reports with the SEC.

9 Have you -- have you looked at any of those announcements?

10 **A.** I have. Yes.

11 **Q.** One of those was from November 10th, 2006. It's
12 Exhibit 434. I believe it's already in evidence.

13 **THE CLERK:** Yes.

14 **BY MR. RICHARD:**

15 **Q.** Do you have that in front of you, sir?

16 **A.** I do. Yes.

17 **MR. RICHARD:** And if you could, enlarge --

18 **BY MR. RICHARD:**

19 **Q.** So just tell us, for the jury, what is this document from
20 November 10th, 2006?

21 **A.** This is a press release issued by Embarcadero
22 Technologies. And it indicates that it submitted to the
23 Securities and Exchange Commission a notification of late
24 filing pursuant to Rule 13(b)(25) of the Securities Exchange
25 Act of 1934 related to its quarterly report on Form 10-Q for

1 the third quarter ended September 30th, 2006.

2 **Q.** Sir, the press release also refers to the company's
3 accounting for certain stock option grants made in 2000 and
4 2001, right?

5 **A.** That's correct.

6 **Q.** Well, assume that the company's stock price dropped when
7 this press release came out. Doesn't that tell us that that
8 historic APB 25 compensation expense must have been materially
9 relevant to reasonable investors?

10 **A.** Not at all.

11 **Q.** Why not?

12 **A.** Well, there was other information contained in its press
13 release. And the last line of the third paragraph of the press
14 release states,

15 "The company is currently unable to
16 determine the impact, if any, this filing
17 delay may have on the completion of the
18 proposed merger."

19 And about two months before this announcement,
20 Embarcadero announced that it agreed to be acquired by a
21 company named "Thoma Cressey"; a private equity firm. And when
22 that announcement was made, Embarcadero's stock price rose
23 substantially, which is typically the case when companies
24 announce that they have agreed to be acquired.

25 When information subsequently comes out that

1 jeopardizes the acquisition, stock prices of those companies
2 typically fall, because the market -- i.e., investors -- now
3 believe that that takeover premium is less certain.

4 And the very likely reason for the decline in
5 Embarcadero's stock price on this date was the fact that the
6 market believed that the takeover had become less likely.

7 **Q.** And why doesn't that tell us that this historic
8 compensation expense under APB 25 was therefore important, or
9 it would have been important to shareholders back in 2000
10 through 2004?

11 **A.** Well, again, the stock-price reaction to this
12 announcement, in my opinion, was related to the fact that the
13 market believed the takeover was less likely; not because of
14 the information in this press release about accounting for
15 certain stock option grants.

16 At previous points in time, there was no takeover
17 proposal. So it's completely irrelevant for understanding
18 whether or not the alleged accounting improprieties in this
19 matter would have had a material impact on Embarcadero's stock
20 price.

21 **Q.** Does this announcement in November 2006 tell potential
22 investors whether there would be a restatement in connection
23 with stock options?

24 **A.** No, there's no reference to a restatement. There's no
25 reference to even which way some possible restatement may

1 occur.

2 At this point, there's just a vague reference to the fact
3 that the company is evaluating its accounting for certain stock
4 option grants made in 2000 and 2001.

5 **Q.** Okay. And you mentioned uncertainty. In general, is
6 there a correlation between uncertainty of the type announced
7 here, and stock price?

8 **A.** Well, as a general matter, the market does not like
9 uncertainty, so uncertainty is not a good thing. And
10 uncertainty of this sort certainly would not be a good thing
11 for Embarcadero.

12 **Q.** Okay. And when you referred to -- that there's other
13 information -- you've talked about the delay in filing, and the
14 unknown impact that might have on the proposed merger. Is
15 there a word in your line of work for that type of other
16 information that's contained in this sort of news release?

17 **A.** Well, in the academic literature it's referred to as
18 "confounding information." When multiple pieces of information
19 hit the market at the same time, it becomes difficult to
20 understand which piece of information is the one that's
21 actually driving the stock price.

22 **Q.** And have you looked at other disclosures regarding
23 Embarcadero Technologies that were submitted in press releases
24 after November 10th, 2006?

25 **A.** Yes, I have.

1 Q. And do those other disclosures also have elements of both
2 uncertainty and confounding information?

3 A. They do. Yes.

4 Q. And what is it about uncertainty or confounding
5 information that makes it, in your opinion, inappropriate to
6 draw a connection between the disclosure of the information and
7 the response to the company's stock price?

8 A. Well, again, the problem is, assuming one has a clean
9 announcement that pertains to the restatement, which we don't
10 have here, but assuming that there was such a clean statement,
11 if that was accompanied by other information, such as "The
12 takeover may not occur. There's uncertainty about the
13 takeover," there would be no scientific basis to conclude that
14 the stock price declined because of the information about a
15 potential restatement.

16 Q. Okay. So I think that brings us back to -- can you tell
17 us how a reasonable investor looking at the economic
18 information between 2000 and 2004 could use or would use the
19 APB 25 noncash compensation expense when making investment
20 decisions?

21 A. Yeah. The APB stock-based compensation expense, in my
22 opinion, would be completely irrelevant to an investor in
23 attempting to measure the impact of the employee stock options
24 on the company's stock price.

25 MR. RICHARD: Okay. I think that's all I have at

1 this point, your Honor.

2 **THE COURT:** All right. We will go ahead and take a
3 break: Our lunch break.

4 If I can ask you to come back and 12:30, slightly
5 shorter than normal by five minutes; but I want to make sure
6 we're able to complete this witness' testimony. I appreciate
7 it.

8 **THE CLERK:** All rise for the jury.

9 (Jury out at 11:58 a.m.)

10 **THE CLERK:** Please be seated.

11 **THE COURT:** Okay. What do we need to talk about?
12 We're going to complete this testimony.

13 It sounds like we're still going to have to go
14 through, tomorrow morning, the completion of Mr. Pattison's
15 testimony.

16 **MR. RICHARD:** Just so I'm clear, the ball's in my
17 court on Mr. Pattison?

18 **THE COURT:** Yep. It's passed to you.

19 And then you will let counsel know whether you intend
20 to call another witness --

21 **MS. LAMARCA:** Yes.

22 **THE COURT:** -- in rebuttal.

23 And this will -- you need to let me know, because
24 that will inform the question of whether we have to have the
25 jury instructions ready. And -- I mean, because if you don't,

1 and everybody rests, then -- then we've got to get the jury
2 instructions finalized, and you deliver your closing arguments.

3 So have you submitted anything?

4 These two instructions we've talked about -- have you
5 all had a chance to talk about it?

6 **MS. LAMARCA:** We learned last night that one of
7 them -- I don't think we've gotten the edits -- but that the
8 defendant might have some editorial suggestions to one, but
9 would reject another.

10 **MR. RICHARD:** I think we can probably talk it through
11 pretty quickly when we talk about the jury instructions.

12 The parties are talking, but you know, our view of
13 what's appropriate and what's overreaching and where you draw
14 that line is a challenge.

15 **THE COURT:** Well, let's do this.

16 I mean, we can -- looks like we'll have to defer
17 until first thing tomorrow morning, in all likelihood, because
18 I have to leave right at around 2:30. So I'd like to have your
19 final positions. And if you'd stipulate, that would be a very
20 short conversation; if not, we'll have to have a more extended
21 conversation.

22 So why don't we get together again at 8:00 tomorrow?

23 **MS. LAMARCA:** Thank you.

24 We should be back here at 12:30?

25 **THE COURT:** Yes. Yes. Thanks.

1 (Whereupon there was a recess in the proceedings
2 from 12:01 until 12:30 p.m.)

3 (The following proceedings were held in open court,
4 outside the presence and hearing of the jury.)

5 **THE COURT:** In terms of the time, you used about 70
6 minutes of your hour and a half. So you've got about 15, 20
7 minutes on redirect.

8 **MR. RICHARD:** Very good. You notice I have my watch
9 out.

10 **THE COURT:** Yes. I noticed that. That was the best
11 examination you've had.

12 (Jury in at 12:32 p.m.)

13 (The following proceedings were held in open court,
14 in the presence of the Jury:)

15 **THE CLERK:** Please be seated.

16 **THE COURT:** Okay. Welcome back one more time. We
17 are now in the process of --

18 Hold on.

19 Okay. I was about to start the cross of
20 Professor Lehn, but in light of this note, what I think I'd
21 like to do is excuse you for a couple of minutes so I can talk
22 with the attorneys.

23 So why don't we take a very short break?

24 (Jury out at 12:33 p.m.)

25 (The following proceedings were held in open court,

1 outside the presence and hearing of the jury.)

2 **THE COURT:** All right. Maybe we should have the
3 witness excused for a moment, if he could step outside.

4 **THE WITNESS:** Sure.

5 **THE COURT:** Professor.

6 **THE WITNESS:** Sure.

7 **THE COURT:** Okay. Very substantive question from
8 someone on the jury.

9 "Professor Kenneth Lehn explained that
10 Exhibit 916, total intrinsic value, was
11 38,316,175, with the understanding that the
12 exercise price was \$30. What impact, if
13 any, does a lower or higher total intrinsic
14 value mean for market participants looking
15 at 10-K filing? For example, \$10 million
16 versus \$60 million? What I'm trying to
17 understand is: Does picking the low for
18 the quarter price have any impact on market
19 perception?"

20 So I think, having read that, I'm going to just leave
21 it to you -- both of you. I'm not a hundred percent sure I
22 totally understand it, but you probably do. And -- to respond
23 to this, if you wish, in your cross and in your redirect.

24 **MS. LAMARCA:** Sure. I think that's fair, your Honor.

25 **THE COURT:** Okay. Anybody want me to read it again?

1 **MR. RICHARD:** No.

2 **MS. LAMARCA:** No.

3 **THE COURT:** Okay. All right.

4 I'm going to announce that I have shared this with
5 counsel.

6 **MS. LAMARCA:** Certainly. Thank you.

7 (Jury in at 12:36 p.m.)

8 (The following proceedings were held in open court,
9 in the presence of the Jury:)

10 **THE CLERK:** Please be seated.

11 **THE COURT:** Okay. You're getting your exercise
12 today. I have shared the question I received from one of the
13 jurors. And I've shared that with the parties and counsel.

14 So -- well, so you'll see if it's answered or not,
15 but I have shared it. So why don't we go ahead and resume and
16 start with cross?

17 **MS. LAMARCA:** Sure.

18 (Witness resumes stand.)

19 **KENNETH LEHN, PH.D.,**

20 called as a witness for the Defendant herein, having been
21 previously sworn, resumed the stand and testified further as
22 follows:

23 **CROSS EXAMINATION**

24 **BY MS. LAMARCA:**

25 **Q.** Good afternoon.

1 **A.** Good afternoon.

2 **Q.** I'm Suzy LaMarca. I'm with the Commission.

3 And Wendy just handed you a binder of documents. We may
4 go through some of them; we may not. I recognize you want to
5 get out today, so I'm going to try to keep my questions snappy.
6 We're all about efficiency.

7 **A.** Thank you.

8 **Q.** So let me just ask you first about sort of the nature of
9 your opinions in this case. If you -- if I understand right,
10 you do not have any opinions that you've expressed in this case
11 about whether Embarcadero's financial statements complied with
12 Generally Accepted Accounting Principles. Is that right?

13 **A.** That's correct.

14 **Q.** Okay. And you would also agree that you're not qualified
15 to give such an opinion, right?

16 **A.** That is correct.

17 **Q.** And you don't have an opinion about whether Embarcadero
18 accounted for the issuance of employee stock options in
19 accordance with APB 25 in the relevant time period. Is that
20 right?

21 **A.** That's correct.

22 **Q.** Okay. And you also don't have an opinion about whether
23 stock options in this case were backdated or granted
24 retroactively. Is that right?

25 **A.** That also is correct.

1 Q. And you didn't find any language in Embarcadero's balance
2 sheet or its income statement or its statements of cash flows
3 or in any of its footnotes to its financial statements between
4 2000 and 2005 that actually disclosed that Embarcadero granted
5 stock options to employees in hindsight or at the end of the
6 quarter. Is that right?

7 A. I don't recall seeing that.

8 I never set out to look for that, but I don't recall
9 coming across that.

10 Q. So that is not your opinion in this case. Is that
11 correct?

12 A. That's correct.

13 Q. And so it's also not your opinion, if I understand
14 correctly, that Embarcadero's public filings accurately
15 disclosed the fair value of employee stock options pursuant to
16 FAS 123, right?

17 A. That's correct.

18 Q. And so, just to sort of orient us, that F-A-S or FAS 123
19 calculation -- that was what you were pointing to on exhibit
20 401: The 2000 10-K, page 47. Do you remember that in your
21 direct?

22 A. I do.

23 Q. Okay. So that's the -- excuse me -- the calculation that
24 the company did, using the Black-Scholes model. Is that right?

25 A. I presume it was using the Black-Scholes model. I don't

1 recall whether they disclosed the methodology specifically that
2 they used. They certainly did list the other variables that
3 would be necessary to implement Black-Scholes.

4 **Q.** And so if -- if I understand this right, they did that in
5 2000, 2001, 2002, 2003, and 2004. Is that right?

6 **A.** That's correct.

7 **Q.** Okay. So I'll ask you. I think this is in that white
8 binder, but it's only a couple of select pages; pages from a
9 longer Exhibit 409, if we could pull that up. It should be, I
10 think, the very last tab in your binder, actually, because we
11 added it at the end.

12 Okay. So this is the December 31, 2002, 10-K. And
13 to make it a little easier to find, I just printed out for you
14 the pages. Page 52, I think, is what we'd like to look at.

15 So actually, Mr. King, if you could, scroll to --
16 well, this is fine, actually, as it is.

17 **BY MS. LAMARCA:**

18 **Q.** Now, do you see here the -- one of the tables that you
19 look at for your analysis: The number of options outstanding?

20 **A.** Yes.

21 **Q.** Okay, but on this very same page --

22 **MS. LAMARCA:** And if, Mr. King, you could blow up --
23 just show the whole page.

24 **BY MS. LAMARCA:**

25 **Q.** Okay. And that number of options outstanding is that

1 lower table that carries over to the second page. Is that
2 correct?

3 **A.** Yes. The number of options outstanding appears twice. In
4 that first set of numbers, if you look at the first column over
5 on the right-hand side, it's the number of options
6 outstanding --

7 **Q.** Mm-hm.

8 **A.** -- which is 4,419. And again, that's in thousands. So
9 it's 4.419 million.

10 It also appears at the bottom of the next set of numbers,
11 because that's the more granular description of the options.

12 **MS. LAMARCA:** Okay. So if you could roll up,
13 Mr. King, to the top of the page, to the top of page 52 --
14 right. There we go.

15 **BY MS. LAMARCA:**

16 **Q.** So on this same -- and this is all in the footnotes to the
17 financial statements, correct?

18 **A.** Correct.

19 **Q.** And it's your opinion, as an economist, that the market
20 uses all of the information in the financial footnotes. Is
21 that right? Incorporates that into the stock price?

22 **A.** Any information that would be relevant for the valuation
23 of companies would be used. That's correct.

24 **Q.** But I think the literature you were pointing at was
25 literature that says the market incorporates information that's

1 in the footnotes. Is that right?

2 **A.** That is correct.

3 **Q.** Okay. So if we look up in that same footnote, we see in
4 prose, in just regular language, that second line.

5 "Since the date of the initial public
6 stock offering, all option grants made
7 during the year were at fair market value,
8 which is defined as the closing share price
9 on the day prior to the option grant date."

10 Do you see that?

11 **A.** I do.

12 **Q.** But that language -- that's not part of your analysis in
13 this case?

14 **A.** Well, I'm not sure what you mean by it's not part of my
15 analysis.

16 That statement, in and of itself, has no relevance for the
17 valuation of the outstanding employee stock options at some
18 later date.

19 **Q.** And so you would agree, then, that your analysis is
20 separate from that language, in that your analysis doesn't
21 change the truth or falsity of that statement? Is that right?

22 **A.** I have no opinion about the truth or falsity of that
23 statement; but regardless of whether that statement is true or
24 false, none of my opinions would -- would be affected by that
25 statement.

1 **MS. LAMARCA:** Okay. And, Mr. King, can we flip back
2 to the prior page?

3 **BY MS. LAMARCA:**

4 **Q.** Okay. I just wanted to point out that that is in that
5 stock options plan footnote, because I'm not sure that was in
6 your little cribbed book.

7 Did you review the testimony -- the trial testimony of
8 Mr. Wallace, the -- an accountant in this case?

9 **A.** I skimmed it. I didn't study it closely.

10 **Q.** Are -- did you note his testimony about whether or not
11 that FAS 123 footnote information was accurate?

12 **A.** I don't recall that offhand.

13 **Q.** Okay. Did you recognize that the company did its FAS 123
14 calculation purportedly on the date of the grant? They
15 calculated the value of those stock options on the date they
16 said they were granted?

17 **A.** I don't recall any specific statements in that regard.

18 **Q.** But you would agree that you didn't use that FAS 123
19 calculation in your analysis. Is that right?

20 **A.** I don't -- I'm not sure I understand what you mean when
21 you say I didn't use it.

22 I make reference to the fact that the fair value
23 disclosures were made; even that fair value disclosure was a
24 disclosure about their estimated fair value of options granted.
25 And, as I've indicated before and as I indicate in my report

1 and in my deposition, what matters to the market is not even
2 the value of the grant options, but the value of all
3 outstanding options as of the date that one is doing the
4 valuation. And none of that information would be affected by
5 whether or not the fair-value calculations of the notes were
6 correct or not.

7 **Q.** And, just so I understand your -- just your general
8 methodology for your analysis, when you're looking at this
9 table of estimated price -- I mean, of prices -- and you
10 have -- you use a weighted-average price, and you apply that to
11 the number of options outstanding, this is all to achieve an
12 estimate. Is that correct?

13 **A.** That is correct.

14 **Q.** Okay. I think also on your direct you mentioned something
15 I think we've heard about options here; that that price -- that
16 the invests -- the person who gets the option receives --

17 I'm sorry. Let me start over.

18 The price on the option is the price that person who gets
19 the option has to pay to exercise it, right?

20 **A.** Just to clarify, when you say "the price on the option" --
21 I think you're referring to the exercise price of the option.

22 **Q.** Yes.

23 **A.** That's correct.

24 **Q.** So they pay that price to exercise their option, right?

25 **A.** And again, just so as not to be confused over who "they"

1 are, the holder of the option will pay the exercise price in
2 order to purchase the share. That's correct.

3 **Q.** Okay. So I'm going to try to ask you a hypothetical
4 question. These are always difficult, so bear with me. And
5 tell me if you lose track of any of the data that's important.

6 But I'm going to ask you to imagine an executive is
7 granted options on January 7, 2002. And assume that the
8 company says, somewhat I like we saw in this exhibit here, that
9 we do not grant options to executives below the fair market
10 value on the day that they are granted.

11 And also assume for this question that the fair market
12 value was \$20 on this January 7 date.

13 So we have a \$20 fair market value. Is that --

14 **A.** \$20 fair market value of the option or of the stock?

15 **Q.** Of the stock.

16 **A.** Mm-hm.

17 **Q.** Okay. And the company says, "We don't grant options at
18 below fair market value." Okay.

19 So also assume that the company reports that the executive
20 was granted options on October 2, 2001, a couple of months
21 earlier, when the market was \$7.

22 So the company tells the public, "We gave him a \$7 option
23 at fair market value," but it's actually lower than the fair
24 market value when it was granted, so a \$13 difference. Is
25 that -- do you get that from my hypothetical so far?

1 **A.** I think I understand so far.

2 **Q.** Okay. So would you agree that if the company had used the
3 true fair market value of \$20, the executive would receive less
4 compensation in that example?

5 **A.** And when you say "if they had used the fair market
6 value" -- of \$20 to establish the exercise price?

7 **Q.** Yes.

8 **A.** As of that date, I would agree, correct.

9 **Q.** In fact, substantially less compensation?

10 **A.** Well, "substantial" would be in the eye of the beholder.
11 It would depend on how many options, and so on and so forth.

12 As of that day, that's correct; but again, the issue that
13 I'm addressing is the information that investors would
14 subsequently have to allow them to value those options. And
15 that information was all fully disclosed.

16 So the value as of a grant date or any earlier date would
17 be irrelevant to any subsequent valuation of those options.

18 **Q.** I understand that. It's irrelevant to your analysis of
19 the subsequent valuation. Is that right?

20 **MR. RICHARD:** Objection. Vague, your Honor.

21 **THE COURT:** Overruled.

22 You can answer the question.

23 **THE WITNESS:** Not just my analysis, but it's
24 irrelevant for the subsequent valuation of the option.

25

1 **BY MS. LAMARCA:**

2 **Q.** Okay. And so -- but you would agree that shareholders
3 care about executive compensation, right?

4 **A.** As a general matter, I would agree with that, yes.

5 **Q.** Okay. And that they care that people in management can't
6 unduly influence their own compensation?

7 **A.** I -- I don't have an opinion as to that.

8 **Q.** Well, you've seen that in the literature, correct?

9 **A.** Well, when you get into words such as "unduly," that
10 starts to take on legal connotations, and connotations that go
11 beyond my expertise as an economist.

12 **Q.** Well, let me ask you. Have you seen that type of
13 literature written in the context of how material this sort of
14 information is to investors?

15 **A.** I'm not sure what you mean by "this sort of information."

16 **Q.** Executive compensation, and the ability of an executive to
17 change the price on certain compensation that he receives.

18 **A.** I don't recall any specific academic literature that
19 analyzes the materiality of that information; but as a general
20 proposition, I can imagine there are cases where that would be
21 material to investors.

22 **Q.** Okay. So let me go back to this hypothetical.

23 We got the \$20 -- the \$20 and the \$7.

24 You would agree, I think -- tell me if you don't -- that
25 if this executive exercised the option, the company would be

1 paid \$13 less than it would have been paid had those options
2 been granted with the actual fair market value on January 7th?

3 **A.** By definition, that's correct.

4 **Q.** Okay. And so that would be money that the company had to
5 forgo when the executive exercised his option?

6 **A.** I don't know what you mean by "forgo." I mean, it's a
7 lower number than it would be if the exercise price has been
8 set at a higher level; but again, the key for valuation is
9 whether that exercise price is disclosed. And when it comes to
10 executives, there's even more granular disclosure of the
11 exercise price.

12 So if we're talking about the chief executive officer or
13 one of the senior officers, you get the weighted-average
14 exercise price of their individual options. So the market --
15 i.e., investors -- would know what that exercise price is. And
16 on subsequent dates, they would always be able to value those
17 executive options.

18 **Q.** Well, you mentioned what I think is an interesting fact;
19 that this information about executive options does get
20 disclosed separately. Is that right?

21 **A.** That is correct.

22 **Q.** And so that's because -- I think you might agree -- people
23 care about how well compensated executives are.

24 **A.** Yeah. I think as a general proposition, that is correct.

25 **Q.** So, for instance, when you were working at the SEC, you

1 know about the filings of these forms called Forms 4 and
2 Forms 5 describing executives' ownership stakes in the company,
3 right?

4 **A.** That's correct.

5 **Q.** Okay. And among those are when an executive is issued an
6 option, he's supposed to file a form that tells the public that
7 he received that option, right?

8 **A.** That is correct.

9 **Q.** And among the information is the price, the date he got
10 that option, and the number of shares, right?

11 **A.** It's been a while since I've looked at the Form 4s, but I
12 think that's correct.

13 **Q.** And nowadays, that data is stuff that people can actually
14 sift through, right, and use for studies?

15 **A.** It's widely available. That's correct.

16 **Q.** Okay. Are you aware of your peers using that information
17 in academic studies?

18 **A.** Yes.

19 **Q.** So in arriving at your opinions in this case, you didn't
20 interview any investors at Embarcadero. Is that right?

21 **A.** That's correct.

22 **Q.** Okay. And you didn't think it would be relevant to your
23 opinions to interview investors, right?

24 **A.** That is correct.

25 **Q.** Okay. Have you heard of investors who make downward

1 adjustments to reported earnings of companies that issue stock
2 options to employees when they're considering whether or not
3 they should invest in those companies?

4 **A.** I'm not aware of any specific investors that do that, no.

5 **Q.** Well, have you heard of investors who have either sold
6 their company's stock or decided not to buy a company's stock
7 because of such a downward adjustment that they made in
8 assessing this company?

9 **A.** I don't recall hearing about any such investors, no.

10 **Q.** Well, would you agree that if an investor did that
11 analysis -- you know, subtracted his considered valuation of
12 options from earnings -- it would be an indication that that
13 investor cared about those stock options, and the impact on
14 earnings?

15 **A.** I'm not sure I understand the question, ma'am.

16 **Q.** Okay. Let me withdraw that question. It was a bad one.

17 Are you familiar with Warren Buffett's annual letters to
18 shareholders for Berkshire Hathaway?

19 **A.** I know he writes them. I don't think I've ever read one.

20 **Q.** Have you read his op-ed pieces?

21 **A.** I probably have over the years. None come to mind, but --

22 **Q.** Well, he's sort of well known for his strong opinions.
23 Would you agree?

24 **A.** He's very well known. That's correct.

25 **Q.** And he likes to share some of his investment opinions with

1 the rest of the nation?

2 **A.** He does.

3 **Q.** So did you ever read Warren Buffett's 1998 letter to
4 shareholders in the Berkshire Hathaway materials to
5 shareholders?

6 **A.** Not that I recall, no.

7 **Q.** Were you aware of Warren Buffett --

8 **MR. RICHARD:** Your Honor, I'm going to object if
9 Counsel's going to read from a hearsay document that the
10 witness has not read, reviewed, relied upon, and which has not
11 been established as an authoritative treatise through this
12 witness. It's absolutely not appropriate, if that was her
13 intent.

14 **MS. LAMARCA:** I have a few more foundational
15 questions for the witness.

16 **THE COURT:** Okay.

17 **BY MS. LAMARCA:**

18 **Q.** Okay. I think you mentioned you have read his op-ed
19 pieces, correct?

20 **A.** Again, none specifically come to mind, but I'm sure that
21 if he's written some, I probably have read them.

22 **Q.** And would you consider Warren Buffett to be a sort of
23 leading presence in the country about investor issues and what
24 is important to investors?

25 **A.** What do you mean by "leading presence"?

1 Q. Okay. Let me ask you. You know that he's a fairly
2 well-known, renowned investor, correct?

3 A. That is correct.

4 Q. And I think your opinions here are about what you think is
5 important to investors. Is that right? To reasonable
6 investors?

7 A. That is part of my opinion. That's correct.

8 MS. LAMARCA: Okay. So, your Honor, I think at this
9 stage we would offer some of Mr. Buffett's statements about
10 stock options. I don't know whether there would be an
11 objection.

12 MR. RICHARD: Yes, your Honor. It's not appropriate
13 cross-examination for this witness. It's not something he's
14 read, reviewed, or relied upon. It's external hearsay. And if
15 they wanted to call an expert to present this material, that
16 was available to them, your Honor.

17 MS. LAMARCA: Let me respond to that.

18 We don't know whether or not Mr. Lehn read what I
19 would show him, unless he can tell us that he didn't, because
20 we do have, in one of the shareholder letters, an op-ed piece.

21 MR. RICHARD: Well, your Honor, we do know what he
22 read, because he submitted a report. Pursuant to Rule 26, he
23 listed every single --

24 THE COURT: Let's just say this. The foundation has
25 not been laid. If a foundation is established of what you're

1 about to introduce is something that has been seen or read or
2 considered by this witness, that's one thing; but so far, that
3 foundation's not been laid. And the fact of --

4 **MS. LAMARCA:** Okay.

5 **THE COURT:** -- possibly seeing an op-ed piece, but
6 nothing specific, is not enough foundation.

7 **MS. LAMARCA:** Well, let me also offer to the Court
8 that with an expert, I think it's just as important what the
9 expert didn't read, in light of the opinions he shares.

10 **THE COURT:** Well, yeah. I think proper way to do
11 it -- there are other ways of getting it in. This is not one
12 of them.

13 **BY MS. LAMARCA:**

14 **Q.** Then I will first ask you to turn and just see if you have
15 read one of these pieces. And I will ask you to turn to what
16 we've marked as Exhibit 662 in your binder. And, if you could,
17 go to the last page of that document.

18 **A.** Okay.

19 **Q.** This is a *Washington Post* article. I think you can tell
20 at the bottom.

21 **A.** Yes, I see that.

22 **Q.** You read the *Washington Post* from time to time?

23 **A.** Every now and then.

24 **Q.** And it's by Warren Buffett. Do you see that?

25 **A.** I do. Yes.

1 Q. Do you think you read this article, or heard about it at
2 the time?

3 A. I don't recall having read it, nor do I remember any
4 discussion about it; but having said that, it's possible that I
5 might have seen it at the time it was published.

6 MS. LAMARCA: Okay. We would ask, with the Court's
7 indulgence, to publish this to the jury.

8 MR. RICHARD: Again, your Honor, this is not
9 appropriate cross-examination.

10 THE COURT: Sustained.

11 BY MS. LAMARCA:

12 Q. Well, let me ask you. During the early 2000s, you would
13 agree, there was a fairly robust debate about the expensing of
14 stock options, correct?

15 A. There was, yes.

16 Q. Okay. And that included important investors weighing in
17 on their views, right?

18 A. That is correct.

19 Q. And it included the Congressional Budget Office, as you
20 mentioned, weighing in on their views?

21 A. Correct.

22 Q. And there were views shared completely contrary to the
23 views described in the Congressional Budget Office memorandum
24 that you discussed earlier today, right?

25 A. I believe there were, yes.

1 Q. So those were investors who thought they should expense
2 those stock options and they should put the full expense in the
3 income statement, correct?

4 A. You know, I don't recall who those investors were, so I
5 couldn't possibly tell you the reason for their position.

6 Q. Well, I guess my question to you really is: Do you recall
7 that there were people calling for this sort of expensing?

8 A. There were people calling for this expensing. That's
9 correct.

10 Q. And would you agree that this was indication that there
11 were people who thought this was very important to be reflected
12 in earnings of a company?

13 A. Presumably, there were some that thought it was important.
14 That's correct.

15 Q. Did you just -- and you don't know whether or not you saw
16 the op-ed piece I showed you at the time. Is that correct?

17 A. That's correct.

18 Q. But you saw others, if you didn't see this one?

19 A. Again, no specific ones come to mind; but insofar that
20 there were op-eds on this topic, I very likely would have
21 reviewed them.

22 Q. Okay. Okay. And I think earlier today -- excuse me -- we
23 were discussing a little bit or heard your discussion a little
24 bit about peer review. You work on certainly journals that
25 review the actual submissions before they're published in the

1 journals, correct?

2 **A.** That's correct.

3 **Q.** And it's sort of a process that vets your opinions, is
4 that right, or whatever it is that you're trying to express in
5 a paper?

6 **A.** Now again, I would view it more as a check on the
7 scientific integrity of the studies.

8 **Q.** And one thing that might come out of a peer-review
9 situation is: You think you have a really good idea, but in
10 the peer-review process, someone's critiques may point to
11 errors or data that's not accurate or something like that. Is
12 that correct?

13 **A.** That's correct.

14 **Q.** Now, you haven't submitted your opinions in this case to
15 that sort of peer-review process. That's right?

16 **A.** Well, I've never submitted an opinion in a court case to a
17 peer-review process.

18 **Q.** Well, let me rephrase the question for you.

19 You haven't written a paper that's been peer reviewed that
20 includes the very same opinions that you are sharing with us
21 today?

22 **A.** Well, as I indicated on direct, I've never published a
23 paper that deals with the specific issue at hand; but I have
24 published papers that look at the relation between releases of
25 information, and how the stock prices of companies change.

1 Q. Okay. But more specifically, you wouldn't find a paper
2 among those that you've published that describes using that
3 tabular information that we saw in the 10-K as a substitute for
4 disclosures about the dates on which stock options were
5 granted. Is that accurate?

6 A. I'm sorry. Can you repeat the question?

7 Q. Actually, I'll just withdraw it. Sounded like it was
8 confusing to you.

9 But you would agree that many academics, and
10 professors at business schools, and economists around the
11 country have written about backdating of stock options,
12 correct?

13 A. Some have. That's correct.

14 Q. And those academics would probably disagree with your
15 opinion that investors wouldn't find backdating material?

16 A. I don't know that any academics have written as to whether
17 the stock-based compensation would be material.

18 I know there are several that indicate that there's no
19 reason to believe that stock-based compensation would have any
20 direct effect on stock price.

21 So again, the issue that I'm addressing in this matter is
22 whether that information is material. And I'm not aware that
23 that has been directly addressed in the academic literature.

24 Q. Well, in this academic literature that you're thinking
25 of -- let's see if we're on the same page. Well, this is

1 peer-reviewed academic literature you're referring to, correct?

2 **A.** Correct.

3 **Q.** Okay. And ultimately, though, those peer-reviewed
4 articles in the academic literature -- they made a pretty big
5 splash when they were picked up by some of the financial press.
6 Is that right?

7 **A.** I don't know which ones you're referring to.

8 **Q.** Okay. So let me -- actually, let me show you an article.
9 If we could turn to Exhibit 663 in your binder, this is a news
10 article dated March 18, 2006, from *The Wall Street Journal*.
11 Have you seen this article before?

12 **A.** I have. Yes.

13 **MS. LAMARCA:** Okay. We would move 663 into evidence,
14 your Honor.

15 **MR. RICHARD:** It's hearsay, your Honor. And it's not
16 something he read, reviewed, relied upon in the course of this
17 engagement; but having read a newspaper article doesn't make it
18 admissible, your Honor.

19 **THE COURT:** All right. I'm not going to admit it at
20 this point.

21 You can use it. You can question him on it, and I'll
22 make a decision later whether it comes in.

23 **MS. LAMARCA:** Sure.

24 **Q.** Well, let me ask you. If you will, do you remember the --
25 the news being broadcast that academics had been helping *The*

1 *Wall Street Journal* in trying to sleuth out whether there was
2 backdating at certain companies?

3 **A.** I don't recall that specifically, no.

4 **Q.** What part of that sounds strange to you?

5 **A.** Most of it.

6 **Q.** Okay. You don't -- you remember this *Wall Street Journal*
7 article, correct?

8 **A.** You say I remember it. I think you asked me if I had seen
9 it, and I said "Yes" --

10 **Q.** Okay?

11 **A.** -- but I don't really remember the details of it.

12 **Q.** In your business school, you use a text that borrows from
13 this article. Is that right?

14 **A.** I believe the Brealey/Myers/Allen book includes this
15 article in one of the chapters, that's correct.

16 **Q.** Okay. And so that text is -- you would consider that a
17 leading text in business schools around the world, wouldn't
18 you?

19 **A.** I do.

20 **Q.** That's an "authoritative treatise," as they call it?

21 **A.** It is. Yes.

22 **Q.** Okay. And that's -- that article talks about what they
23 call "the perfect payday," right?

24 **A.** The article from *The Wall Street Journal* does. That's
25 correct.

1 Q. And that's the article that's in the Brealey and Myers
2 text, correct?

3 A. Right. And I think it's included in the Brealey/Myers
4 text in -- under a topic, "Finance in the News," as an
5 illustration of topics related to finance that appear in the
6 newspapers.

7 Q. Okay. So let me ask you. You're familiar with a peer of
8 yours named Erik Lie, correct?

9 A. I am. Yes.

10 Q. And you recognize him as someone who has written quite a
11 bit in the options-backdating arena. Is that right?

12 A. That's correct.

13 Q. In fact, he was one of the people who provided information
14 to *The Wall Street Journal* in the spring of 2005 about
15 companies that he thought might be backdating. Is that right?

16 A. I -- I don't know that firsthand.

17 Q. Well, you're familiar with his -- his work, his
18 literature, his -- the articles he's authored?

19 A. Right. I'm familiar with the papers that he's published;
20 but beyond that, I'm not familiar with any interaction he might
21 have had with *The Wall Street Journal*.

22 Q. Okay. Let me ask you to turn to what we've marked as
23 Exhibit 227. It's kind of a poor copy quality, as we like to
24 say here so often every day; but do you recognize this as the
25 22nd chapter of the Brealey and Myers corporate-finance book?

1 **A.** Again, without vouching for every page, it does appear to
2 be Chapter 22 of that book.

3 **Q.** Okay. If you could, turn to the page within there that's
4 numbered 604. And I tell you it's -- 603 has a number, but I
5 don't see it on 604.

6 Do you see that?

7 **A.** I'm sorry. Which one, ma'am?

8 **Q.** 604.

9 **A.** Yes, I do see it.

10 **Q.** "Finance in the News"?

11 **A.** Correct.

12 **Q.** "The perfect payday"?

13 **A.** Right.

14 **MS. LAMARCA:** Okay. We would offer, your Honor,
15 Exhibit 227.

16 **MR. RICHARD:** Again, your Honor, this treatise is
17 hearsay. It's not how experts are examined or cross-examined.
18 I can move into evidence a number of treatises, and that's just
19 not -- it's hearsay, your Honor.

20 **MS. LAMARCA:** I will lay a further foundation,
21 your Honor.

22 **THE COURT:** All right.

23 **BY MS. LAMARCA:**

24 **Q.** Mr. Lehn, you used this treatise in forming your opinions,
25 didn't you?

1 **A.** I believe I made reference to it.

2 **Q.** Seven times, in your report?

3 **A.** I don't recall the exact number offhand.

4 **Q.** Well, in order to describe how it was that one could value
5 an option, you cited to the Brealey and Myers treatise; this
6 very chapter, 22, correct?

7 **A.** That is correct.

8 **Q.** And you described this as an authoritative treatise?

9 **A.** That's correct.

10 **MS. LAMARCA:** We would move it in evidence,
11 your Honor, as an authoritative treatise.

12 **THE COURT:** Are you talking about the entirety of
13 227?

14 **MS. LAMARCA:** Yes.

15 **MR. RICHARD:** Your Honor, all she's established is
16 that she can now ask him questions out of the treatise. It
17 doesn't make the treatise itself admissible. This is pretty
18 basic cross-examination of an expert. It doesn't make the
19 entire treatise admissible.

20 **MS. LAMARCA:** Your Honor, this treatise and this
21 chapter were used by this expert. And that wouldn't even be
22 the requirement for an authoritative treatise under the federal
23 rules.

24 **THE COURT:** Well, now, just because an expert relies
25 on a particular treatise or whatever -- unless you can convince

1 me otherwise, I'm not convinced that that automatically results
2 in, per se, admissibility.

3 **MS. LAMARCA:** Well, it is admissible when the expert
4 relies on it and he recognizes it as an authoritative treatise,
5 which Mr. Lehn did.

6 **THE COURT:** Is there something you want to ask him
7 about this piece?

8 **MS. LAMARCA:** Sure. Yes, I do.

9 **THE COURT:** Why don't you do that first?

10 **MS. LAMARCA:** Okay.

11 **BY MS. LAMARCA:**

12 **Q.** Can you turn to page 604?

13 **A.** Sure.

14 **Q.** And this is the description of the perfect payday. Do you
15 see that?

16 **A.** I think it's actually the article, if I recall correctly.

17 **Q.** Well, this is sort of an excerpt from it. If you -- if
18 you look at the description at the top of the page. Do you see
19 that?

20 **A.** Yes. Okay.

21 **Q.** Okay. And so you would agree with me that, in balancing
22 out all of the information that this text wants to deliver to
23 finance students or business students, they've chosen to talk
24 about this stock -- how stock-options backdating sort of hit
25 the market? Is that right?

1 **A.** Well, I'm not sure what you mean by: To illustrate a
2 point, they chose this article.

3 I, as a teaching method, very frequently -- almost every
4 day -- bring in articles from *The Wall Street Journal* that
5 address topics in finance that can be a springboard for
6 discussion. And it doesn't mean you endorse everything in the
7 article. And, quite the contrary, I often distribute articles
8 that have things in there that I think are incorrect, and it
9 makes for good class discussion. And you want students to read
10 things that will get them to think about the topic.

11 So I think the fact that they included this *Wall Street*
12 *Journal* article under a category called "Finance in the News"
13 is more of a teaching tool than, necessarily, an endorsement of
14 what was in that article.

15 **Q.** Well, if I could ask you actually to take a look at the
16 article that we looked at a moment ago, I think you might agree
17 with me that this is not simply a copying of that article,
18 which is Exhibit 663, into the textbook. It's the textbook's
19 consideration of the article. Is that right?

20 **A.** It -- just to read the book, what it says -- it says,

21 "The following extracts are taken from
22 the article."

23 And then it goes on and includes those extracts.

24 **Q.** Yeah. And you're familiar with how the -- these "Finance
25 in the News" sort of describe the -- they excerpt it, and talk

1 about what's important about the article? Is that accurate?

2 **A.** I don't know whether it's what's important about the
3 article, or something that would be provocative that, after
4 reading a chapter about the theory of options, it would inspire
5 students to think about the application of that theory to these
6 topics. And I think it is more in that spirit that textbooks
7 include articles from newspapers.

8 **Q.** Okay. Well, let me ask you a few questions. Would you
9 agree that a key purpose of stock options is to give recipients
10 an incentive to improve their employer's performance, including
11 the employer's stock price?

12 **A.** In many cases, I would agree with that.

13 In some cases, I think that's probably less of a reason to
14 grant stock options.

15 **Q.** Well, would you agree that authoritative literature
16 considers that a key purpose of stock options?

17 **A.** Yes, I think the literature generally would recognize that
18 that is a key reason for granting stock options.

19 **Q.** And so the effect is, if there's no stock gain for a
20 person who gets an in-the-money stock option, then there's no
21 profit on the options.

22 **A.** I would disagree with that.

23 **Q.** That if there's no -- there is no stock gain, that there's
24 no profit on the options when you get an in-the-money -- I mean
25 at-the-money option.

1 **MS. LaMARCA:** I'm sorry; did I say "in-the-money"?

2 **THE COURT:** Yes.

3 **MS. LaMARCA:** I apologize. Let me withdraw the
4 question.

5 **BY MS. LAMARCA:**

6 **Q** The premise of granting options to employees at the money
7 is that they will work to build the value of the share price.
8 Is that correct?

9 **A** Again, I think it is a little more complicated. There
10 certainly are many, many cases where that may be a primary
11 motivation for granting options. But, it also is the case
12 companies, especially young companies, are cash-constrained,
13 and they're growing.

14 And again, as we indicated, when stock options are granted
15 to employees, that represents a non-cash expense, if you will.
16 So for companies that are cash-constrained, granting options to
17 new employees can be a way to compensate them without
18 necessarily paying them cash. And, that would be separate from
19 any incentive effect.

20 **Q** So that's a way that the company can have lower cash
21 outlay, by granting options to employees. Is that correct?

22 **A** Well, again, the way I would phrase it is if a company is
23 cash-constrained, as a lot of young growing companies are, then
24 employee stock options can be very attractive, because it
25 allows you to attract good workers without paying any immediate

1 cash outlay.

2 **Q** So, and whether or not they happen to be cash-constrained,
3 a company can choose to give options instead of cash
4 compensation. Correct?

5 **A** That is correct.

6 **Q** So, backdating options so that they carry a lower price
7 would run counter to the goal, that key goal that we mentioned
8 a moment ago, the incentive. Is that right?

9 **A** No. Quite the contrary. That, if an employee is granted
10 an in-the-money option, then they have even more to lose if the
11 stock price declines. So, granting an in-the-money option
12 could actually strengthen the incentives that the employees
13 face.

14 **Q** Well, you would agree that many academics wouldn't share
15 your opinion that that aids the incentive value of a stock
16 option, wouldn't you?

17 **A** I can't speak for all academics. I'm not aware of any, as
18 I sit here, that would -- would disagree with that.

19 **Q** That would disagree with your opinion?

20 **A** Correct.

21 **Q** Okay. Well, as you sit here, can you think of
22 authoritative texts that might disagree with that opinion? For
23 instance, Brealey and Myers?

24 **A** As I sit here, I don't recall that they disagree with what
25 I just said.

1 Q You don't recall one way or the other, but you haven't
2 read this (Indicating) recently. Is that right?

3 A "This" being *The Perfect Payday*?

4 Q This portion of this chapter, yes.

5 A I haven't reviewed it all that recently, so I don't recall
6 specifically what they say about that.

7 Q Okay.

8 So, if we could go back a moment to these academics who
9 were doing studies about stock options backdating, you were
10 aware of their work at the time. Is that correct?

11 A Some of their work, that's correct.

12 Q And Erik Lie is one of the people whose work you were
13 aware of?

14 A That's correct.

15 Q Were you also aware of a gentleman named Professor
16 Yermack, at NYU?

17 A I'm familiar with his work, yes.

18 Q And that was earlier in 1998.

19 A I don't specifically recall his work on the so-called
20 backdating of stock options, but I'm familiar with his work,
21 generally.

22 Q I'm sorry; I didn't mean to suggest that his work was
23 about backdating specifically, but about stock options that
24 appeared to be low-priced.

25 A I -- I generally remember. I don't remember the details

1 of his work, but I do know that he worked in that area.

2 **Q** Well, would you agree that one of the things these
3 academics were writing about was they were trying to figure out
4 how it was these options were so low-priced, these executive
5 options?

6 **A** You know, I would have to go back and look at the articles
7 and read the motivation to see what the objective of what they
8 were doing was. I don't recall specifically, as I sit here.

9 **Q** Well, you understood that Erik Lie's work was aimed at
10 looking at executive compensation, and trying to figure out how
11 it was that they seemed to have favorable stock prices for
12 their option grants.

13 Is that correct?

14 **A** Yeah, well, my general recollection is that Erik was
15 identifying that the exercise prices of executive options were
16 often close or equal to the low price over some period prior to
17 the granting of the option. And, he was curious as to why that
18 was. And that led to his empirical research.

19 **Q** So, that's very helpful. So, he was curious about why
20 these options were granted -- seemed -- how they arrived at
21 those low prices.

22 Is that right?

23 **A** That's correct.

24 **Q** And so, he did research to try to sleuth it out or figure
25 it out; is that accurate?

1 **A** That is accurate.

2 **Q** Would you agree that it wouldn't make a lot of sense to do
3 that kind of research if you didn't think that it would be
4 important to the investing public?

5 **A** Well, this is where I don't recall that Erik addressed the
6 issue as to whether stock-based compensation expense was
7 material, which is a separate issue from identifying that the
8 exercise prices tended to be close to the low price during a
9 quarter or a year.

10 And again, based on my testimony earlier today, it doesn't
11 really matter what the intrinsic value of the option was at the
12 grant date or measurement date or approval date. All of that
13 is historic information.

14 In assessing the materiality of the accounting expenses at
15 issue here, all that matters is that the market participants
16 have the information that would let them independently value
17 the options at a subsequent date. And all of that information
18 was disclosed in Embarcadero's SEC filings.

19 So, what Professor Lie was doing is quite different than
20 what I'm doing in this particular matter.

21 **Q** So, well, let's just back up a little bit to Professor
22 Lie's research.

23 They were dealing with executive stock options, right? As
24 opposed to all types of employee stock options?

25 **A** I don't recall.

1 Q Well, you would agree that they have access to the dates
2 on which executive stock options were supposedly granted, from
3 those Forms 4 and other sorts of filings that you've pointed
4 to. Correct?

5 A That's correct.

6 Q But they don't have access to that kind of granular detail
7 for employee stock options, right?

8 A Well, they would from companies' 10-K filings. Just as
9 Embarcadero discloses that information, so do other companies.

10 Q Well, you would agree that they did not do these sorts of
11 analyses on employee stock options, did they?

12 A As I sit here, I don't recall.

13 Q Do you remember what happened to the stock prices of the
14 companies that were described in these *Wall Street Journal*
15 articles, when the news hit about potential for backdating at
16 those companies?

17 A My -- my recollection is that they declined when the
18 newspaper article was published.

19 Q Would you agree that the matter was drawing concern from
20 investors at the time?

21 A I'm not sure what you mean by "the matter."

22 Q The matter of whether or not these stock options that
23 these companies had granted to executives had been backdated.

24 A I -- I think you would have to look company by company to
25 determine whether or not it was of concern to investors in

1 those companies.

2 But, again, one can't confuse the issue of the accounting
3 for the stock options with the fact that when revelations are
4 made that there might have been so-called backdating, that
5 there are other collateral effects separate from the accounting
6 expenses that may cause the stock price to decline, such as the
7 cost of a restatement, possible litigation, possible management
8 turnover.

9 And all of these issues may be related to the issue of
10 so-called backdating, but they're completely separate from
11 whether or not the accounting had a material effect on the
12 company's stock price.

13 **Q** So, you mentioned many collateral effects. Would you
14 consider -- have you heard of the phrase "agency costs"?

15 **A** Yes.

16 **Q** And, tell me if you would agree that this is a relatively
17 fair description of "agency costs": The costs of shareholders
18 having to rely on other persons -- management -- to manage the
19 assets. The costs of actually monitoring that.

20 **A** Monitoring costs would be one component of agency costs.

21 **Q** Uh-huh.

22 **A** But I think more broadly, agency costs are loss of value
23 when a principal -- in this case, the stockholder -- hires
24 someone else -- in this case, a manager -- to look after his
25 capital, if you will.

1 Q So agency costs, according to the academic literature,
2 increase when you have questions about how the managers -- the
3 agents -- are performing the tasks that they describe to you,
4 such as granting stock options.

5 Is that accurate?

6 A I don't think that is accurate.

7 Q Well, let me ask you this. Do you think that the -- there
8 is academic research about agency costs related to the
9 backdating of stock options?

10 A There -- there probably is. And again, I don't recall
11 specific studies. But there have been a few that have been
12 published, and they probably looked at different so-called
13 corporate governance variables in their analysis.

14 Q Well, you wouldn't consider those agency costs to be
15 collateral effects, would you?

16 A When you say "those agency costs," I'm not sure which ones
17 you are referring to.

18 Q Let me just take it a step back.

19 Agency costs are not what you were referring to when you
20 were talking about collateral effects. Is that right?

21 A I -- I wouldn't include agency costs as part of the
22 collateral effects.

23 Q You would include agency costs as part of the valuation
24 that the market makes for the company's stock. Right?

25 A Yes. Presumably, the company -- the market, the

1 investors, would incorporate agency costs in their valuation of
2 a company.

3 **Q** Okay. So, I noted on your direct that your opinion is
4 founded in part on how many options the company has
5 outstanding, at a given point. Correct?

6 **A** That -- that's one of the variables that investors would
7 want to know in assessing the impact that employee stock
8 options have on the company's stock price.

9 **Q** And when you say that's one of the variables they would
10 want to know, I mean, without that variable, without that
11 number, they can't arrive at your estimate, can they?

12 **A** Well, I wouldn't quite put it that way. I mean, an
13 estimate is an estimate, and we use models to estimate the
14 impact that employee stock options have on companies' stock
15 price.

16 Black-Scholes is one model. There are other models. All
17 models entail an estimate.

18 One of the inputs into the models is the number of
19 employee stock options. If one were to substitute a different
20 number, everything else equal, you would presumably get a
21 different number. But whether it was materially different is
22 not at all clear.

23 That -- whenever you do an estimate, there's a confidence
24 interval around that estimate. And so, just changing the
25 numbers, in and of itself, would not necessarily change your

1 overall estimate.

2 **Q** Well, whether changing the numbers changed your overall
3 estimate -- let me step back a second.

4 So, your estimate leaves room for quite a bit of error for
5 the number of options outstanding? Or not?

6 **A** Well, I don't know what you mean by "error for the number
7 of options outstanding." That you would take the number of
8 options outstanding as disclosed by a company, and incorporate
9 that as an input into your model.

10 **Q** Do you know whether the number of options outstanding as
11 reported by Embarcadero was accurate?

12 **A** From a valuation point of view, there is reason to believe
13 that the numbers that are reported would be more accurate than
14 the numbers that the SEC would have wanted them to report.

15 For example, in a company's 10-K filing, hypothetically,
16 if, in fact, options were granted to employees, and the grant
17 date was the end of December on a given year, and the
18 allegation is that the company should have used a different
19 grant date, a subsequent grant date that spilled over to the
20 next year, and if, hypothetically, a company were to restate
21 their financials, the requirement would be to show that there
22 were fewer options outstanding in the relevant year.

23 If a company were to restate their financials, it would be
24 less informative to the market, because by the time the market
25 receives the 10-K in March, what the market wants to know are:

1 How many options are there outstanding?

2 And if, in fact, a restatement caused that number to be
3 lower, then the market would have less information about the
4 number of options outstanding when it received the 10-K.

5 Q And your example that you just shared with us implied
6 certain select known options granted shortly after this cutoff
7 date of 12-31. Is that right?

8 A Under my hypothetical, that's correct.

9 Q But it didn't include any other options that could have
10 been granted in the swing period, that investors don't see. Is
11 that accurate?

12 For instance, let me expand upon your hypothetical. In
13 addition to these grants that should have had a later date,
14 under your hypothetical, if the company continued to grant
15 stock options before they filed their 10-K, well, that wouldn't
16 be reflected in the 10-K, either, would it?

17 A Can you repeat that? I'm sorry.

18 Q Sure. So, your hypothetical dealt with options that
19 should not have been included, as of 12-31 of a given year.
20 Correct?

21 A Correct.

22 Q Because those options were actually granted later. Right?

23 A That's correct.

24 Q And, if the company did grant other options later as well,
25 but before they filed their 10-K for that 12-31 period, but

1 after that 12-31 cutoff, those wouldn't be included in the 10-K
2 either, would they?

3 **A** If I'm following your hypothetical, that's correct.

4 **Q** So, 10-Ks have a cutoff date so that people can see
5 information as of a given date, and they know that they could
6 compare that information to other periods and other companies.

7 Right?

8 **A** That -- that's part of it. But again, what matters is
9 that when the 10-K is disclosed, which would be typically two
10 to three months after that fiscal year is ended, what investors
11 really want is the most recent, up-to-date data they can
12 obtain.

13 **Q** So, I know that you focused on options outstanding,
14 overall.

15 **A** Uh-huh.

16 **Q** But you also looked at options granted during a given
17 period. Correct?

18 **A** Well, again, with -- with the -- to place this in proper
19 context, what matters for purposes of estimating the impact of
20 employee stock options on a company's stock price is the total
21 number of options outstanding.

22 With respect to this stock-based compensation expense that
23 is at issue in this matter, it's the value of the options that
24 were granted over some period of time. And for purposes of
25 addressing that issue, I make reference to the intrinsic value

1 and the fair value of the options granted.

2 But in my opinion, that's not even important to investors
3 in assessing the impact that employee stock options have on a
4 company's stock price.

5 Q Well, certainly, any -- the number of options granted in a
6 given period affects, obviously, the options outstanding at the
7 end of that period. Correct?

8 A Right. But assuming that the options outstanding are
9 already disclosed, that particular number adds no additional
10 relevant information.

11 Q I'm not certain I understood your answer. Let me rephrase
12 my question.

13 The amount of options granted during a period is added to
14 the amount outstanding from the prior period. Correct?

15 A That is correct.

16 Q And then the other options that are either cancelled or
17 exercised are subtracted, as you described earlier. Right?

18 A That's correct.

19 Q So it's important to know -- in order to know what the
20 options outstanding are at the end of a period, it's important
21 to be confident that the number granted is accurate.

22 Correct?

23 A That is correct.

24 Q Are you aware of or have you seen any evidence in this
25 case of overstatement, at times, of options granted during a

1 given period?

2 **A** I'm not -- not aware of that.

3 **Q** Are you aware of the deletion of options that were never
4 formally provided to employees in a given period?

5 **A** No. But again, what I focused on was the accounting
6 expenses at issue. And if there are other dimensions of the
7 stock option granting process that are at issue, those are not
8 ones that I considered in my analysis.

9 **Q** So, your analysis is limited to the compensation -- the
10 effect of the compensation charges that were not recorded as an
11 expense.

12 **A** Right. As I indicated this morning, my assignment was to
13 analyze the evidence as it pertains to the materiality of the
14 accounting expenses at issue here.

15 **Q** Okay. And so --

16 **MS. LaMARCA:** I don't want to take too much longer,
17 sorry.

18 **BY MS. LAMARCA:**

19 **Q** In this case, I think defense counsel asked you if you had
20 been compensated for your work in forming these opinions.

21 Is that right?

22 **A** That's correct.

23 **Q** Okay. And so, your compensation is \$950 an hour for your
24 time here?

25 **A** That's correct.

1 Q And that includes working on the report, if you did; is
2 that accurate?

3 A That's correct.

4 Q And that includes looking at any of the data that we've
5 talked about. Is that right?

6 A That's correct.

7 Q And then appearing at trial, et cetera?

8 A That's correct.

9 Q Okay. And then, other persons who work with you at a
10 company called Lexecon, they're also compensated for their work
11 in this case. Right?

12 A I -- I presume they are. I don't have firsthand knowledge
13 of that.

14 Q Well, I should have phrased it differently.

15 That they prepare bills that are paid for work in this
16 company -- in this case. Is that correct?

17 A I don't get involved in any of that, so I don't know
18 firsthand. But I presume that's the case.

19 Q Well, correct me if I'm wrong, but you are receiving a
20 percentage of those billings, aren't you, for your efforts?

21 A I haven't yet, but I -- my contractual arrangement is that
22 I -- that I do. But I haven't, and I don't -- I'm not privy to
23 what those billings are.

24 Q Is the percentage that you are going to receive about
25 15 percent of those billings?

1 **A** It's either 15 or 20. I don't recall, offhand.

2 **Q** And, you don't know how much they've billed yet?

3 **A** No.

4 **Q** Would it surprise you to learn that by the time that your
5 report was prepared, that they had billed, I believe, more than
6 -- or roughly \$200,000?

7 **A** I didn't know that, but it wouldn't surprise me.

8 **Q** Is there any reason why you don't know what those billings
9 are, if you're contractually entitled to those monies?

10 **A** Time is scarce, and I just haven't inquired about it. I
11 haven't looked at it.

12 **Q** Do you know whether there -- excuse me. Has anyone from
13 Lexecon mentioned to you whether or not those billings have
14 exceeded \$500,000 yet?

15 **A** I've never had any discussion with people at Lexecon as to
16 the billings.

17 **Q** And, someone at Lexecon drafted your report. Is that
18 correct?

19 **A** They -- the initial draft, under my direction, was
20 performed by a staff member.

21 And it's similar to processes that I've used when I have
22 been retained by the SEC. That I have discussions with the
23 consultants; I tell them the outline. I describe to them the
24 type of analyses that I would like to have done. We have many
25 discussions about the analyses.

1 And then, depending on my schedule, I may ask them to do
2 some initial drafting, which they do. They send to me, and
3 then I aggressively edit it. And it goes back and forth. And
4 it ultimately becomes a final report, and it's my report.

5 **Q** And those persons at Lexecon, to arrive at those opinions,
6 they provide you that draft report, and that's what you use to
7 edit. Is that correct?

8 **A** No; I think you're being very unfair. The process that
9 I've used in this matter is identical to the process that I've
10 used when I have been retained by the Securities and Exchange
11 Commission. They're my opinions, and it's my report. There is
12 some initial drafting by staff members, but it is my report.

13 It's not unlike when you do an academic paper, and there
14 might be some research assistant. You ask them to draft
15 certain sections where they collected data. They then edit it.
16 It's your report, but there is some assistance in the initial
17 drafting.

18 And the procedure is identical to what I've done when I've
19 been retained by the SEC.

20 **Q** Let me ask you this. Has it been several years since
21 you've been retained by the SEC?

22 **A** I was retained by the SEC in a matter as recently as a
23 year ago. And I'm presently working with the SEC in four
24 matters, in which we're distributing money to investors of
25 mutual funds who were hurt by alleged wrongdoing.

1 So, I continue to work with the SEC.

2 **Q** That was a matter where you were hired several years ago,
3 I think, based on your disclosures in this case?

4 **A** Which ones, ma'am? I'm sorry.

5 **Q** The one that you were referring to about the mutual fund
6 shareholders.

7 **A** Well, the mutual fund, I'm actually retained by mutual
8 fund advisors, but subject to approval by the SEC. And there
9 are four such matters. And I work closely with Commission
10 staff on those matters.

11 And there was a matter involving litigation where, as
12 recently as a year ago, the SEC had asked me to form an opinion
13 as to whether certain information was material. And that
14 matter settled. And I think it was a year ago, August.

15 So, I continue to work with the SEC.

16 **Q** So, in this case, just so I get a feel for what you -- you
17 did to arrive at your opinions, you weren't looking at the
18 information about how stock options were backdated to arrive at
19 these opinions. Is that correct?

20 **A** Again, my focus was on whether the accounting expenses at
21 issue were material.

22 **Q** So, would the answer to that be no, that wasn't part of
23 the materials that you were looking at?

24 **A** That's correct.

25 **Q** Okay.

1 **MS. LaMARCA:** I think that's what we have, Your
2 Honor.

3 **THE COURT:** Thank you. Any redirect?

4 **MR. RICHARD:** A couple questions.

5 **REDIRECT EXAMINATION**

6 **BY MR. RICHARD:**

7 **Q** Professor Lehn, do you know what Ms. LaMarca means when
8 she keeps referring to "backdating"?

9 **A** It's -- in a vague sense. But, that requires knowledge
10 about the distinctions between grant dates and measurement
11 dates and approval dates, which, as an economist, I view as
12 largely a legal issue.

13 So, I think I know what she means by it, but I don't have
14 any precise definition as to what constitutes backdating.

15 **Q** Are you aware of any stock option agreement in this case
16 where anyone changed a date from one point in time to another
17 point in time?

18 **A** I'm not aware of that.

19 **Q** You were asked a number of questions about your
20 compensation, and people you've worked with. Have you given us
21 your honest opinions today?

22 **A** Yes, sir.

23 **Q** Would your opinions be different, if your billing rate was
24 different?

25 **A** Not at all.

1 **Q** When you work with the SEC, do you charge them the same
2 rate you're charging my client?

3 **A** I'm not -- the last case I worked on, as I indicated to
4 Ms. LaMarca, was a year or so ago. And, at the time, I was
5 charging the SEC the same rate that I charge other clients.

6 **Q** Okay. And, you were asked -- see if I have this right --
7 about discussions you've had, whether your opinions in this
8 matter have been peer-reviewed.

9 Prior to being retained in this case, did you share your
10 opinions about the materiality of stock option expenses with
11 the SEC?

12 **A** I did, yes.

13 **Q** And can you explain the context of that, even though it
14 wasn't peer-reviewed?

15 **A** Yes. About -- probably about three years ago, I received
16 a call from a staff member with whom I had worked at the SEC,
17 telling me they had a large number of backdating cases, and
18 they were looking for some experts to form opinions as to
19 materiality. And, would I be interested. And I told them I
20 would be happy to look at materials.

21 They sent materials. And I told them the same thing that
22 I've effectively told the Court today. That, because of the
23 disclosures in the footnotes, investors have all the relevant
24 information they need to understand the impact that employee
25 stock options have on the company's stock price. And, the

1 information on the income statement about stock-based
2 compensation expense is not material.

3 And we had two or three phone conversations to that
4 effect. And the Commission and I agreed that, you know, I
5 would not pursue any work with the SEC on this particular
6 issue.

7 **MR. RICHARD:** I think that's all I need, Your Honor.

8 **THE COURT:** Thank you. Any recross?

9 **MS LaMARCA:** No, Your Honor.

10 **THE COURT:** All right, thank you.

11 Professor Lehn, you may step down. Thank you.

12 **THE WITNESS:** Thank you, Your Honor.

13 (Witness excused)

14 **THE COURT:** Okay, then, we can resume at this point.

15 We still have some time, with the -- the redirect, I believe it
16 is, of Mr. Pattison.

17 **MR. RICHARD:** I think we're -- I guess I can check my
18 notes, but I think we will leave the Record where it stands.

19 **THE COURT:** Okay.

20 **MR. RICHARD:** Call it a day on that.

21 **THE COURT:** All right. And then, you had no further
22 witnesses, then, at this point?

23 **MR. RICHARD:** Well, there's a matter we -- not at
24 this point, Your Honor.

25 **THE COURT:** All right. All right.

1 So, the testimony of Mr. Pattison has been concluded
2 at this point, and therefore -- and it appears that defense
3 doesn't have another witness to call?

4 **MR. RICHARD:** I think that's right, Your Honor.

5 **THE COURT:** Okay.

6 **MR. RICHARD:** In light of the -- some considerations
7 we've discussed, I think that's correct.

8 **THE COURT:** All right. The ball passes back to the
9 Commission, whether the Commission wants to call any rebuttal
10 witnesses at this point.

11 **MS. LaMARCA:** And at this point, we -- to be
12 completely frank, we need time to make that determination. And
13 we were -- the persons who we would call, if we call anyone,
14 are not available yet because we were told they -- wouldn't be
15 called until tomorrow.

16 **THE COURT:** Okay. All right.

17 **MS. LaMARCA:** But we will certainly be able to inform
18 the Court today.

19 **THE COURT:** All right. Okay.

20 Well, we are going to call an early recess today.
21 All that marching in and out paid off, so you can leave 15
22 minutes early. We will return tomorrow, and we may or may not
23 have witnesses. If we do, we'll hear further testimony and
24 examination. If not, we are actually approaching the point
25 where we would begin instructing you and having the attorneys

1 prepare their closing arguments.

2 So, there you go. Thank you. And please remember,
3 do not do any independent research; do not discuss this case
4 with anyone; and don't form any opinions. Thank you.

5 **THE CLERK:** All rise for the jury.

6 (Jury excused)

7 (The following proceedings were held in open court
8 outside of the presence of the jury:)

9 **THE CLERK:** Please be seated.

10 **THE COURT:** Okay. When will you have your decision,
11 Ms. LaMarca?

12 **MS. LaMARCA:** I think we would know by 5:00 today,
13 Your Honor.

14 **THE COURT:** Okay.

15 **MS. LaMARCA:** Is that early enough to inform the
16 Court?

17 **THE COURT:** That's fine with me. And, as long as you
18 -- by close of business.

19 **MS. LaMARCA:** Certainly.

20 **MR. RICHARD:** What -- what time?

21 **MS. LaMARCA:** Five.

22 **MR. RICHARD:** Okay.

23 **THE COURT:** And, same rules about disclosing the
24 exhibits and that sort of thing.

25 **MS. LaMARCA:** Yes.

1 **THE COURT:** Now, so now, the jury instruction matters
2 is going to be accelerated. Let me just tell you what my
3 intent is at this point.

4 I've given the parties two sets of jury instructions.
5 One was the -- I called them preliminary, which I've already
6 read. The other is the final instructions, which I provided
7 with cross-outs and commentary. I have now cleaned those up,
8 and removed all commentary, and sources, and this sort of
9 thing.

10 The only one, in reviewing this, that I have removed
11 so far is there was one about interrogatory answers, which
12 doesn't seem to apply here. I removed that.

13 And so, subject to the instruction -- you call it the
14 empty-chair instruction -- empty-chair?

15 **MS. LaMARCA:** Yes, I heard you. Sorry.

16 **THE COURT:** And the question about what the Court
17 should say about any consequence, since there's nothing here
18 about damages or anything else, --

19 **MS. LaMARCA:** Uh-huh.

20 **THE COURT:** -- those are the only two things I'm
21 thinking about adding.

22 Now, I know Mr. Richard had raised a comment about
23 the inappropriateness of giving instructions -- perhaps coupled
24 with the motion for judgment as a matter of law, their position
25 that some of these instructions don't apply because essential

1 elements have not been made out.

2 I -- my initial view on that is that it is a
3 close-enough question that I've taken this matter under
4 submission, and I think to not give a jury instruction would
5 preempt that JMOL matter. And therefore, I'm not inclined to
6 remove a substantive instruction, at this point, on that basis.

7 But I'll hear any comments, since we're going to have
8 to decide this quickly.

9 **MR. RICHARD:** Sure. And, the only two areas that I
10 think -- and there may be others, but the two that come to mind
11 immediately that the evidence would not support the giving of
12 the instruction would be an instruction based on recklessness,
13 because there was no testimony as to what ordinary care for a
14 controller would be.

15 And, we've attached the *Shanahan* discussion from
16 another SEC stock options case. And so, I think that's one
17 that's worth taking a look at, especially in light of the
18 Government's position immediately before trial, that they would
19 be pursuing only intentional-based claims.

20 But, to give an instruction on recklessness when
21 there's absolutely no evidence as to what an ordinary,
22 responsible -- or any controller would or wouldn't do should be
23 looked at.

24 All we've had is the testimony of some folks saying,
25 "I would have expected Mr. Pattison to know x, Y and Z." But

1 that doesn't give the jury any guidance as to what the standard
2 is from which there has been this gross departure. And we can
3 discuss that further in the context of that specific
4 instruction.

5 The other instruction that comes to mind upon which
6 there has been no evidence to justify it would be this
7 deliberate-ignorance instruction that has been engrafted solely
8 from criminal cases, having nothing to do with the civil
9 allegations. I didn't like the instruction when it was
10 offered. I didn't think there would be evidence to support it.

11 To try to cobble together a deliberate -- a
12 deliberate-ignorance notion that is not even supported in these
13 types of cases, let alone on the evidence here, to show a
14 witness an 80-page PowerPoint and say, "Doesn't this say this?"
15 It -- he gave whatever testimony he gave about that PowerPoint.
16 That doesn't rise to the level of some deliberate ignorance
17 under the criminal cases that -- from which that construction
18 is borrowed.

19 So, I think, those two. And again, I've been
20 somewhat preoccupied, so I haven't focused on Your Honor's last
21 batch of jury instructions, but will be -- you know, those are
22 two that I think are worth discussing.

23 **THE COURT:** Let me hear the Commission's response.

24 **MS. LaMARCA:** To just respond to those two, we do
25 believe that there's plenty of evidence for each of those.

1 And I think that it has -- it was not our position,
2 pretrial or during trial, that recklessness is not at issue
3 here, because that is the standard under 10b, as well as
4 intentional conduct.

5 **THE COURT:** The argument there, that there's been no
6 evidence -- Mr. Richard is implying there needs to be evidence,
7 not just -- the instruction talks about extreme departure from
8 ordinary care.

9 **MS. LaMARCA:** Exactly.

10 **THE COURT:** And, I think his argument is that there's
11 no been no evidence about ordinary care, in this context, for a
12 controller.

13 **MS. LaMARCA:** And we believe there has been.

14 **THE COURT:** What would that be?

15 **MS. LaMARCA:** Among the evidence that we've seen is
16 -- especially today, there was a focus on the time period when
17 Mr. Pattison was preparing a document for the company's
18 internal control processes. He was supposed to be describing a
19 process that he was following on a routine basis. And he was
20 working with other professionals.

21 And he did not disclose key pieces of that process
22 that included what we like to call -- I know, not uniformly
23 accepted -- "backdating," or picking the low price and picking
24 the matching date.

25 And, that kind of information was -- the information

1 surrounding this was being sought by those professionals. And
2 at least, at a very least, required a question from the
3 Defendant: "What do you mean? What are you talking about?"

4 And not asking that question is a departure, an
5 extreme departure from the standards of ordinary care.

6 **THE COURT:** Well, that's the question. What's the
7 evidence of ordinary -- I mean, obviously, in some cases -- if
8 it's a banana peel, it's kind of obvious.

9 But in the case of a controller, what's your legal
10 position? Need there be specific evidence of ordinary care in
11 the context of this particular job in, you know, corporation,
12 or --

13 **MS. LaMARCA:** Our position is this. That in the
14 context of a case where we learn of what the -- the Defendant's
15 job is, as controller, and how he is to perform it, and who
16 relies on him, including audit committee members, accountants,
17 and other persons at the company, and even consultants helping
18 to prepare something like a 404 narrative, that those persons
19 interactions and their description of what they were doing and
20 expected from the Defendant are evidence of what he -- what his
21 legal duty was.

22 In other words, the standard by which he would be
23 measured.

24 **THE COURT:** Okay.

25 **MR. RICHARD:** All right. And I guess our response

1 would be two-fold, Your Honor.

2 One, the SEC has never cited any legal authority,
3 whatsoever, for the argument that a layman can determine the
4 standard of care for accountants.

5 Point two, there are at least four cases that we're
6 aware of, describing the need for standard-of-care evidence.
7 We cited the *SEC v. GLT* --

8 **THE COURT:** Is this in your JMOL brief?

9 **MR. RICHARD:** I think it is Page 14 of our motion,
10 yes. So there's three SEC cases, including *Guenthner* and
11 *Pasternak*, as well as the *Vernazza* case from the Ninth Circuit,
12 *Vernazza versus SEC*, regarding the need for expert testimony as
13 to industry practice relevant to show the standard of care
14 that's necessary on a recklessness inquiry.

15 So --

16 **THE COURT:** So your position is absent expert
17 testimony, in this context of an accountant or a controller,
18 that -- that the evidence, all the factual evidence would fail,
19 as a matter of law.

20 **MR. RICHARD:** I think that's correct. But I think
21 that Your Honor doesn't need to necessarily reach the issue of
22 whether you need expert testimony, although most cases say you
23 do, because in this case there's no testimony as to what an
24 ordinary controller or a reasonable controller or ordinary
25 accountant or reasonable accountant should or shouldn't do,

1 under these circumstances.

2 So --

3 **THE COURT:** Well, why isn't there enough -- if there
4 is no per-se rule, why isn't there enough for the jury to
5 infer, hearing what they did about what his duties were, what
6 he did, whom interacted with him, and as Ms. LaMarca says, who
7 turned to him for documents, drafting, information, et cetera,
8 et cetera --

9 **MR. RICHARD:** Because if you don't have the standard
10 set as to "Here's the bar" (Indicating), it's impossible to
11 judge a gross departure from that bar.

12 To say, "Here's how did I my job," and then leave it
13 to the jury to guess whether that's a gross departure from
14 ordinary care for a controller or accountant is -- I mean,
15 that's why the cases do say you need to start with establishing
16 the standard of care.

17 And that's usually done through expert testimony.

18 **THE COURT:** Do you have a response to these cases
19 that he says establishes, almost, a per-se rule?

20 **MS LaMARCA:** Yes. As our -- our reading of those
21 cases is the opposite. That they do not establish a per-se
22 rule. In fact, that they are weighted against over-emphasis on
23 expert testimony about a person's duty under the securities
24 laws. They will permit expert testimony at times if it's
25 helpful, but they certainly don't require it.

1 And in fact, we don't know of any authority that
2 requires that we present evidence of the standard of ordinary
3 care for a controller. In fact, we had this argument pretrial,
4 and we thought it had been resolved.

5 **THE COURT:** All right. I'll look at these; I'll look
6 at that issue. And with respect to the -- the deliberate
7 ignorance, we did debate that, and I ruled on that.

8 And I find that, again, if -- assuming this is a
9 legally proper instruction, which you take issue with, but
10 which I've decided, I think there's enough -- I'm not going to
11 take it away from the jury at this point. So, I'm going to
12 keep those instructions in.

13 I will look at the recklessness to see. And my
14 inclination is to take a good hard look. If I'm absolutely
15 convinced that the Ninth Circuit says you've got to have expert
16 evidence on this, that's one thing.

17 If it doesn't say that, or if I don't see it saying
18 that, for the reasons stated by the Commission, I think
19 there's, again, enough to at least allow this instruction to go
20 to the jury.

21 Without prejudice to the JMOL action, which we can
22 still argue at greater length, if necessary -- if the jury
23 comes back, that motion is under submission. So, we can deal
24 with it at that point.

25 So, what would be helpful are those two other

1 instructions.

2 **MS. LaMARCA:** Certainly.

3 **MR. RICHARD:** So we can deal with that tomorrow,
4 around 8:15.

5 **MS LaMARCA:** Okay. So, just to be clear, we will
6 again approach the defense about our -- the ones that we have
7 drafted, see if there's any agreement.

8 And then, if so, we will file those tonight. If not,
9 we will file the competing ones.

10 **THE COURT:** Okay.

11 **MR. RICHARD:** And, Your Honor, it takes ten seconds
12 to kind of express the view that if -- if there's a general
13 instruction that says the jury is not to consider the wit- --
14 the people who are not present, witnesses who are not present,
15 or did not testify, did not appear in these proceedings, that's
16 fine.

17 But to instruct the jury that there were other
18 Defendants, and go on in any greater detail -- so that --
19 that's -- there is a general instruction that would simply say
20 that people who didn't testify or appear, you're not to draw
21 any -- you're not to consider that. And we wouldn't argue
22 that.

23 But to go beyond that, and say other -- "There were
24 other Defendants, and how matters turned out, you're not to
25 consider" --

1 **THE COURT:** Or you can do something in between.

2 "You're not to consider what may or may not have happened with
3 respect to other people, including the people we keep hearing
4 about."

5 **MR. RICHARD:** And, that's fine. I think it's the
6 calling them "Defendants," or suggesting that there was an
7 outcome in some other proceeding --

8 **THE COURT:** Well, that might -- yeah, well, that may
9 be a concern. But, I suspect there's something in between,
10 other than "Don't worry about witnesses who weren't here," and
11 stating sort of the more obvious.

12 I want you to think about that.

13 **MR. RICHARD:** That's helpful.

14 **MS. LaMARCA:** Thank you.

15 **THE COURT:** Good. Thank you.

16 (Proceedings concluded at 2:02 p.m.)

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_____/s/ Lydia Zinn_____

Lydia Zinn, CSR 9233, RPR, FCRR

Tuesday, September 21, 2010